MEMOIR & DEFENSE

# My Time with Supply-Side Economics

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Supply-side economics is a major innovation in economics. It says that fiscal policy works by changing relative prices and shifting the aggregate supply curve, not by raising or lowering disposable income and shifting the aggregate demand curve. Supply-side economics reconciled micro- and macroeconomics by making relative-price analysis the basis for macroconclusions. The argument is straightforward: relative prices govern people's decisions about how they allocate their income between consumption and saving and how they allocate their time between work and leisure.

The cost to the individual of allocating a dollar of income to current consumption is the future income stream given up by not saving and investing that dollar. The present value of that income stream depends on marginal tax rates. The higher the marginal tax rate, the lower is the value of the income stream, and the cheaper is the price of current consumption. Thus, high marginal tax rates discourage investment and thereby lower the rate of economic growth.

The cost to a person of allocating additional time to leisure is the forgone current or future earnings. The value of the forgone income depends on the rate at which additional income is taxed. The higher the marginal tax rate, the cheaper the price of leisure. Tax rates thus affect the supplies of labor and entrepreneurship, the investment rate, the growth rate, and the size of the tax base.

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Supply-side economics presented a fundamental challenge to Keynesian demand management. Keynesian multiplier rankings, which showed government spending to be a more effective stimulus to the economy than tax-rate reduction, had turned demand management into a ramp for government spending programs. Powerful vested interests organized in support of this policy. All Republicans could do was to bemoan the deficits necessary to maintain full employment.

Keynesian economists objected to the fiscal emphasis on relative price effects. They claimed that people have targeted levels of income and wealth regardless of the cost of acquiring them. A tax cut would let them reach their targeted levels of income and wealth sooner, resulting in a reduction of work effort or labor supply. Lester Thurow at MIT used this reasoning to argue that a wealth tax is a costless way to raise revenue because the income effect runs counter to and dominates the substitution effect. A wealth tax would cause a rise in labor supply as people worked harder to maintain their desired after-tax wealth.

The claim that the elasticities of work and saving to tax rates were zero or negative possibly could be true for some individuals but not in the aggregate. Keynesians did not realize that in making this argument, they were aggregating a series of partial-equilibrium analyses while ignoring the general-equilibrium effect. If the aggregate response to a tax-rate reduction is less effort, total production would fall, and people would not be able to maintain their living standards. In public-debate forums, I explained to Keynesian Nobel laureates sent to squash the rebellion that their argument that people would take their tax cut in the form of increased leisure undercut their own interpretation of expansionary fiscal policy just as thoroughly as it undercut the supply-side interpretation that was their target.

Supply-side economics came out of the policy process. It was the answer to the "malaise" of the Carter years, "stagflation," and the worsening "Phillips curve" trade-offs between inflation and unemployment. Supply-side economists convinced policymakers, both Democrat and Republican, that "stagflation" resulted from a policy mix that pumped up demand with easy money while restricting output with high tax rates. This argument carried the day with policymakers before it did with academic economists, who resented the diminution of their policy influence and human capital.

I played a lead role in the economic policy change (Roberts 1984), but Norman Ture and Robert Mundell were the first supply-side theorists. Art Laffer recalls that Mundell discussed the relative-price effects of fiscal policy at the University of Chicago in the early 1970s, when Laffer joined the economics faculty. Laffer also recalls many conversations with Ture in Washington, D.C., in 1967 and 1968 in which Ture, a Chicago Ph.D., described the relative-price effects of fiscal policy. My conversations with Ture in 1975 solidified my own thinking.

The interest-rate approach to the cost of capital predates the income tax. Supply-side economics brought the insight that marginal tax rates enter directly into the cost of capital (Robbins, Robbins, and Roberts 1986). A reduction in marginal tax rates makes profitable investment opportunities that previously could not return a normal profit after meeting tax and depreciation charges.

This perspective provided a more promising policy for stimulating investment than the Keynesian idea of using monetary policy to drive market interest rates below the marginal return on plant and equipment. In a world of global capital markets, central banks cannot alter the real interest rate in financial markets independently of the technological, tax, and risk factors that determine the cost of capital. During the 1970s, such attempts in the United States resulted in higher nominal interest rates and a rise in inflation.

The conventional view, which stressed the interest rate as the important factor in the cost of capital, suffered from the misconception that higher government revenues from increased taxation can spur capital investment by lowering deficits and interest rates or by creating budget surpluses and retiring debt. Because taxation reduces investment and economic activity, the only certain way to reduce "crowding out" is to cut government expenditure.

Supply-side economics also added the insight that the total resources claimed by government (tax revenues plus borrowing) is an inadequate measure of the tax burden because it ignores the production that is lost owing to disincentives. In this perspective, a tax cut can be real even if it is not matched dollar for dollar with a spending cut. The relative-price effects will expand economic activity, thus making the tax cut partially self-financing even if people expect that taxes will be raised in the future to pay off government debt incurred by cutting tax rates.

As a policy, supply-side economics first won over Republicans in the House. Jack Kemp was the leader. Next, it won over important Democratic committee chairmen in the Senate, such as Joint Economic Committee chairman Lloyd Bentson and Finance Committee chairman Russell Long. For example, in 1979 and 1980 the annual report of the Joint Economic Committee abandoned demand management and called for the implementation of a supply-side policy. By the time of Ronald Reagan's election as president, there was bipartisan support in Congress for a supply-side change in the policy mix. Inflation would be restrained with monetary policy, and output would be expanded by lowering the after-tax cost of labor and capital.

President Reagan's economic program was contained in a document called *A Program for Economic Recovery,* published on February 18, 1981. Contrary to many uninformed academic economists' assertions, the administration did not base its program on a "Laffer curve" forecast that the tax cut would pay for itself. The administration decided not to fight the battle for a dynamic revenue forecast and used the standard static revenue forecasting still in use today. Tables in the document show that the administration assumed that every dollar of tax cut would result in a dollar of lost revenue.

The tax cut was expected to slow the growth of revenues. Receipts as a percentage of gross national product (GNP) were expected to fall from 21.1 percent in 1981 to 19.6 percent in 1986. To avoid rising deficits, the budget plan showed the necessity of slowing the growth of spending below the contemporary policy projections.

The "Reagan deficits" occurred because inflation fell substantially below the budget assumptions, and therefore real spending rose above projections (Roberts 1992, 2000). As the budget deficits resulted from the unexpected rate at which inflation declined, the deficits themselves could not be a source of inflation and high interest rates. The economic establishment and Wall Street mistook a result of unanticipated disinflation as a potential cause of inflation. Consequently, the inflation and high interest rates predicted by many economists never materialized.

Reagan's economic policy caused an increase in the willingness to hold dollars. The decline in velocity, together with tight monetary policy and a smaller tax component in the cost of labor and capital, broke the back of inflation more rapidly than forecasts, constrained by concepts such as "core inflation," had predicted. The decline in the income velocity of money during the 1980s is proof that the long recovery was not a Keynesian demand phenomenon. A demand-led recovery would have increased the income velocity of money.

Supply-side economics provides a different explanation of the U.S. current and capital accounts during the 1980s than the critique that blames the "twin deficits" on an excessive Keynesian expansion. The 1981 business tax cut and the reductions in personal income tax rates in mid-1982 and mid-1983 raised the after-tax rate of return on real investment in the United States relative to that in the rest of the world. Consequently, instead of exporting capital, the United States retained it. U.S. balance of payments statistics show that a collapse in U.S. capital outflows accounts for the shift of the net capital inflow from negative to positive between 1982 and 1983. U.S. capital outflows declined $71 billion. Foreign capital inflow fell by $9 billion.

During the 1982–84 period, when the story of foreign money pouring into the United States to finance overconsumption was fixed firmly in the world's consciousness, there was no significant change in the inflow of foreign capital into the United States. U.S. capital outflow, however, collapsed from $121 billion to $24 billion, a decline of 80 percent. The money stayed at home, and we financed our own deficit.

The collapse in U.S. capital outflow is clearly the origin of the large trade deficit, which by definition is a mirror image of the capital surplus. Not until 1986, with the dollar falling and U.S. interest rates low, did the foreign capital inflow increase significantly. The "twin deficits" theory was just another Keynesian hoax.

Among politicians, Democrats moved early to identify with supply-side economics. Republicans, however, were divided. The Republican establishment had no stake in a policy identified with outsiders such as Jack Kemp and Ronald Reagan. With a view to the succession, establishment Republicans portrayed Reagan's policy as extreme and in need of their moderate hand. Political self-serving by the Republican establishment aided and abetted the Keynesian misinterpretation of Reagan's supply-side policy.

## References

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