Reflections

What Is Supply-Side Economics? Four Decades Later Wikipedia and Academic Economists Still Don't Know

PAUL CRAIG ROBERTS

It is difficult for truth to emerge anywhere. History, politics, science, medicine, crime and punishment, any academic subject, neighborhood gossip—wherever one looks, falsehood abounds. It is no different for supply-side economics.

It has been four decades since the Reagan administration gave up on Keynesian demand management, which had resulted in "stagflation"—that is, worsening Phillips curve trade-offs between employment and inflation. Now thirty-nine years later (if the *Wikipedia* entry on supply-side economics most recently updated on June 28, 2020, can be trusted), journalists, academic economists, and whoever writes *Wikipedia* entries have no idea what supply-side economics is or what the problem was that it addressed successfully. Indeed, I would be hard pressed to imagine a more incorrect explanation of

Paul Craig Roberts was senior research fellow, Hoover Institution, Stanford University; held the William E. Simon Chair in Political Economy in the Center for Strategic and International Studies at Georgetown University; and was associate editor of the *Wall Street Journal* and assistant secretary of the US Treasury.

The Independent Review, v. 25, n. 3, Winter 2020, ISSN 1086–1653, Copyright © 2020, pp. 467–470.

supply-side economics than the one in *Wikipedia,* buttressed by uninformed statements by Gregory Mankiw, Paul Krugman, and Alan Blinder.

No one has been more intimately involved with supply-side economics than I. I was an expositor and an advocate. In 1975, I penned an article for U.S. representative Jack Kemp calling for a supply-side policy that was published in the Sunday *Washington Star*. I was involved in the policy process in the House and Senate, where the ground was prepared among Republicans and Democrats for the emergence of a supply-side policy. I drafted the Kemp–Roth bill that became what the media called "Reaganomics." I taught the Congress how to use the budget process to enact a supply-side policy. I was appointed Treasury assistant secretary and tasked with getting a supply-side policy out of the administration for a congressional vote. I was invited to give the annual state-of-the-economy address to the combined economic graduate students and faculties of Harvard and MIT where I received a standing ovation. It was my peer-reviewed book *The Supply-Side Revolution*—published by Harvard University Press in 1984, remaining in print for decades, and appearing in a Chinese-language edition—that explained supply-side theory and the problems of getting it into practice. I was the one who wrote the supply-side entry for *The New Palgrave Dictionary of Money and Finance* (MacMillan 1992 Vol. 3) and for McGraw-Hill's *Encyclopedia of Economics* (1994) in the 1980s, plus a separate entry for the Laffer curve in the former (Vol. 2). I am the economist who explained the theory and practice in the leading scholarly economic journals in Germany and Italy. I am the one who explained it to the French government, for which I received the Legion of Honor. I explained it in the journal *The Public Interest* in the United States and in British bank and policy magazines. I wrote numerous *Wall Street Journal, Business Week,* and other articles about supply-side economics. I debated Lawrence Klein and other leading Keynesian academics before university audiences. Yet I do not appear in the *Wikipedia* entry except in a note at the end containing a list of supply-side articles, which includes only one article written by me published in *The Independent Review* in the winter of 2003 ("My Time with Supply-Side Economics," *The Independent Review* 7, no. 3 [Winter]: 393–97), twenty-two years after I had successfully launched a new economic policy.

Wikipedia has created a false picture of supply-side economics that bears no relationship to the acutal policy. Academics have spent four decades criticizing a nonexistent policy.

What is this nonexistent policy? Tax cuts that pay for themselves.

The Laffer curve has nothing to do with supply-side economics. It is merely an expository device that illustrates that high and low tax rates can produce the same tax revenue. Perhaps the Laffer curve should be known as the Ibn Khaldun curve because it has been traced to this fourteenth-century Arab scholar. There can be little doubt that Ibn Khaldun had much worthwhile to say, but he did not provide the basis for supply-side economics.

The origin of the misinformation that "Reaganomics" is based on a claim that tax cuts pay for themselves is mysterious. It cannot be found in official documents. As the official and publicly available documents show, the Reagan administration forecast that every dollar of tax cut would result in a dollar of lost tax revenue. It was a static-revenue estimate. The Reagan budget submitted to Congress showed large multiyear budget deficits. The Office of Tax Analysis in the Treasury had no capability of making revenue feedback estimates.

The Reagan administration predicted a 100 percent revenue loss from the supply-side tax cut. I presided over this forecast myself. We were not interested in revenue effects. The Treasury was interested to learn if the relative price effects were sufficient to allow the economy to grow without having to pay for it with a rising rate of inflation.

Supply-side economics in Congress and in the Reagan administration addressed the worsening Phillips curve trade-offs. These worsening trade-offs were worrisome to Democrats and Republicans alike. They meant that the management of economic policy associated with the postwar boom was no longer working. The Keynesian solution was wage-and-price controls—an incomes policy. Congress had recent experience with trying to control one price—that of oil—and wanted nothing to do with a scheme to control all prices. Leading Democrat committee chairmen in the Senate, such as Lloyd Bentsen (Joint Economic Committee) and Russell Long (Finance Committee), listened to me more carefully than did Republicans. It was the Joint Economic Committee under the chairmanship of Democrat Lloyd Bentsen that published the first Senate document calling for a supply-side economic policy. The committee's staff director was James Galbraith, the son of John Kenneth Galbraith.

The originality of supply-side economics is its demonstration that some forms of fiscal policy—specifically a change in the marginal rate of taxation of income—will shift the aggregate supply schedule. Why was this a novel and important breakthrough, indeed a more important one than those for which the Nobel Prize in economics is usually given?

The answer is that in Keynesian economics a change in marginal tax rates only shifts the aggregate demand schedule. Aggregate demand increases if marginal tax rates are lowered—a policy used to combat unemployment. Aggregate demand decreases if marginal tax rates are raised—a policy used to combat inflation. By neglecting the impact of tax rates on supply, as inflation was moving people into higher marginal tax brackets, the increase in consumer demand was encountering diminished incentives to increase output to meet the demand. Therefore, prices rose along with output and then more than output.

Why did prices rise as people encountered higher tax brackets? They rose because of the behavior of two important relative prices that economists had overlooked. The price of current consumption in terms of forgone future income and the price of leisure in terms of forgone current income. The higher the marginal tax rate, the less the future income forgone by consuming income rather than saving and investing it. Thus, the cheaper current consumption is in terms of forgone future income, and the lower saving

rates are. For example, the 98 percent tax rate on investment income in the United Kingdom meant that the cost of purchasing a Rolls Royce in terms of foregone future income was essentially zero.

The higher the marginal tax rate, the less current income forgone by enjoying more leisure. Thus, the cheaper leisure is in terms of forgone current income. Thus, we witnessed medical practices that closed at noon on Fridays and high absenteeism in the manufacturing workforce on Mondays.

Because marginal tax rates were high when Reagan came to office—70 percent on investment income and 50 percent on personal income—supply-side economists concluded that the worsening Phillips curve trade-offs between employment and inflation were due to the neglect of the impact of fiscal policy on the supply side of the economy.

The Reagan administration and Congress reduced the marginal tax rates across the board not in order to trickle down income or to balance the budget but to lower the high relative prices that were restraining the response of output to demand. Although economists have failed to notice the obvious, the supply-side policy succeeded in eliminating the worsening Phillips curve trade-offs. The economy again was able to expand without having to pay for the expansion in terms of a rising rate of inflation.

How is it possible for such a clearly explicated policy in every public and scholarly forum and the obvious passing away of Phillips curve worries not to be noticed by academic economists and financial journalists?

Perhaps the numerically dominant Keynesians were protective of their human capital. Most economists and financial journalists in the 1980s also were liberals more interested in taxing the rich than in noninflationary economic growth. Journalists took their cue from the Keynesians, who were traditionally the spokespersons for economics. Many journalists also looked down on a movie actor and his rhetoric.

But the primary reason why the clear explication of supply-side economics wasn't noticed is the authority of existing paradigms. The Keynesians were in authority. They were ensconced in the departments of all the leading universities except the University of Chicago. They had trained the economic and financial journalists. They were the ones who testified before Congress and were the consultants to the Federal Reserve and the corporations. If you were not Keynesian, a career was hard to come by.

The problem of changing regimes in science and scholarship is the same as in political and social life. Thomas Kuhn wrote about it in *The Structure of Scientific Revolutions* (Chicago: University of Chicago Press, 1962). My Oxford professor Michael Polanyi wrote about it even more successfully. Those responsible for change often pay a price. As Niccolò Machiavelli said in *The Prince,* "There is nothing more difficult, more perilous, or more uncertain of success than to take the lead in introducing a new order of things."

About a year ago, I read that an economist had put forward the idea that fiscal policy could shift the aggregate-supply schedule. I meant to contact him but got busy with other things. More important truths are being buried every day.

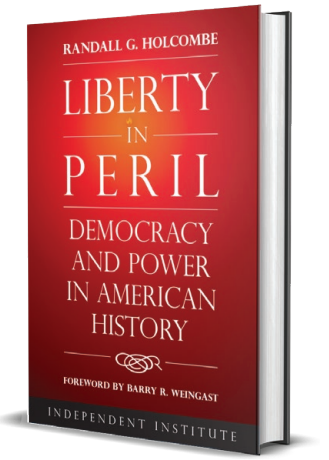
SUBSCRIBE NOW AND RECEIVE A FREE BOOK!



"***The Independent Review*** does not accept pronouncements of government officials nor the conventional wisdom at face value."
—**JOHN R. MACARTHUR**, Publisher, *Harper's*

"***The Independent Review*** is excellent."
—**GARY BECKER**, Nobel Laureate in Economic Sciences

Subscribe to ***The Independent Review*** and receive a free book of your choice such as ***Liberty in Peril: Democracy and Power in American History***, by Randall G. Holcombe.



Thought-provoking and educational, ***The Independent Review*** is blazing the way toward informed debate. This quarterly journal offers leading-edge insights on today's most critical issues in economics, healthcare, education, the environment, energy, defense, law, history, political science, philosophy, and sociology.

Student? Educator? Journalist? Business or civic leader? Engaged citizen? This journal is for YOU!

Order today for more *FREE* book options

SUBSCRIBE

The Independent Review is now available digitally on mobile devices and tablets via the Apple/Android App Stores and Magzter. Subscriptions and single issues start at $2.99. **Learn More.**



Download on the App Store | GET IT ON Google Play | Available on MAGZTER

INDEPENDENT INSTITUTE, 100 SWAN WAY, OAKLAND, CA 94621 • 1 (800) 927-8733 • ORDERS@INDEPENDENT.ORG