LECTURE FIVE – PART EIGHT

Reagan's Supply Side Platform

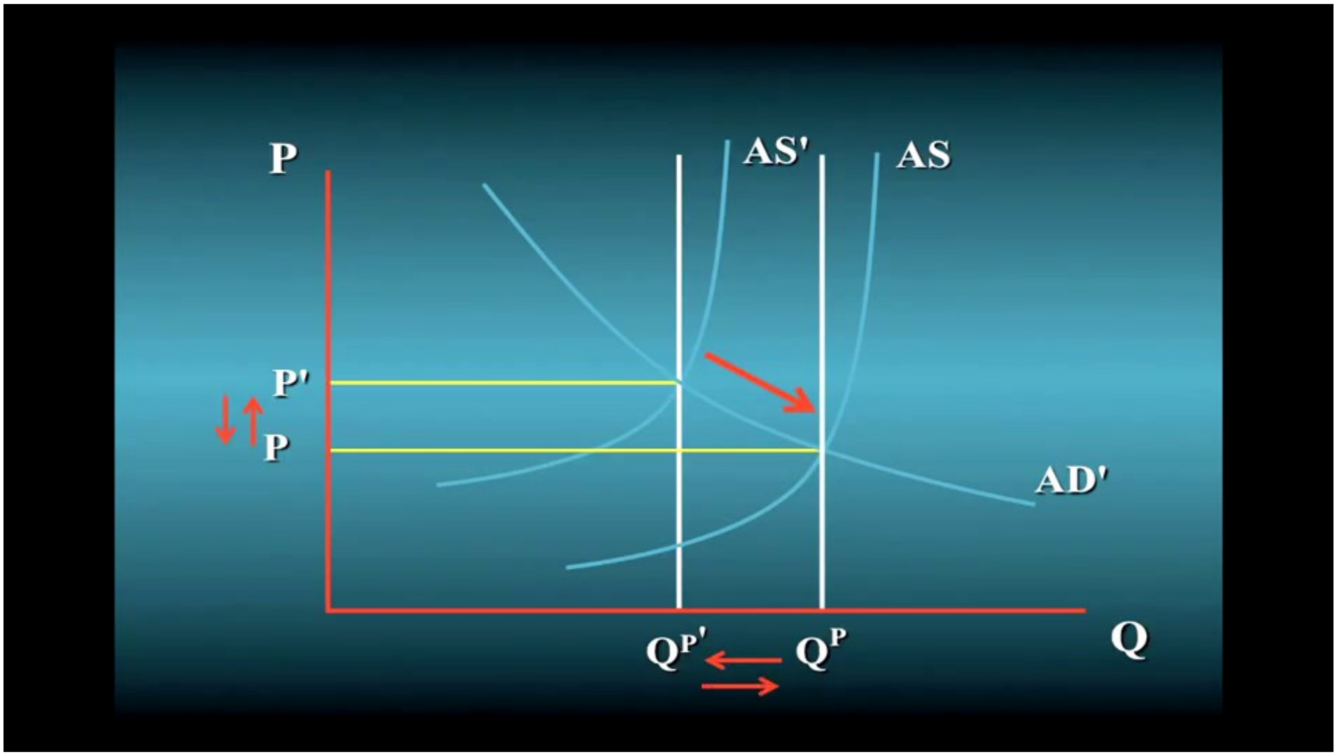
- Cut taxes
- Increase tax revenues
- Accelerate growth
- Do it WITHOUT inducing inflation

Supply Side vs. Keynesianism

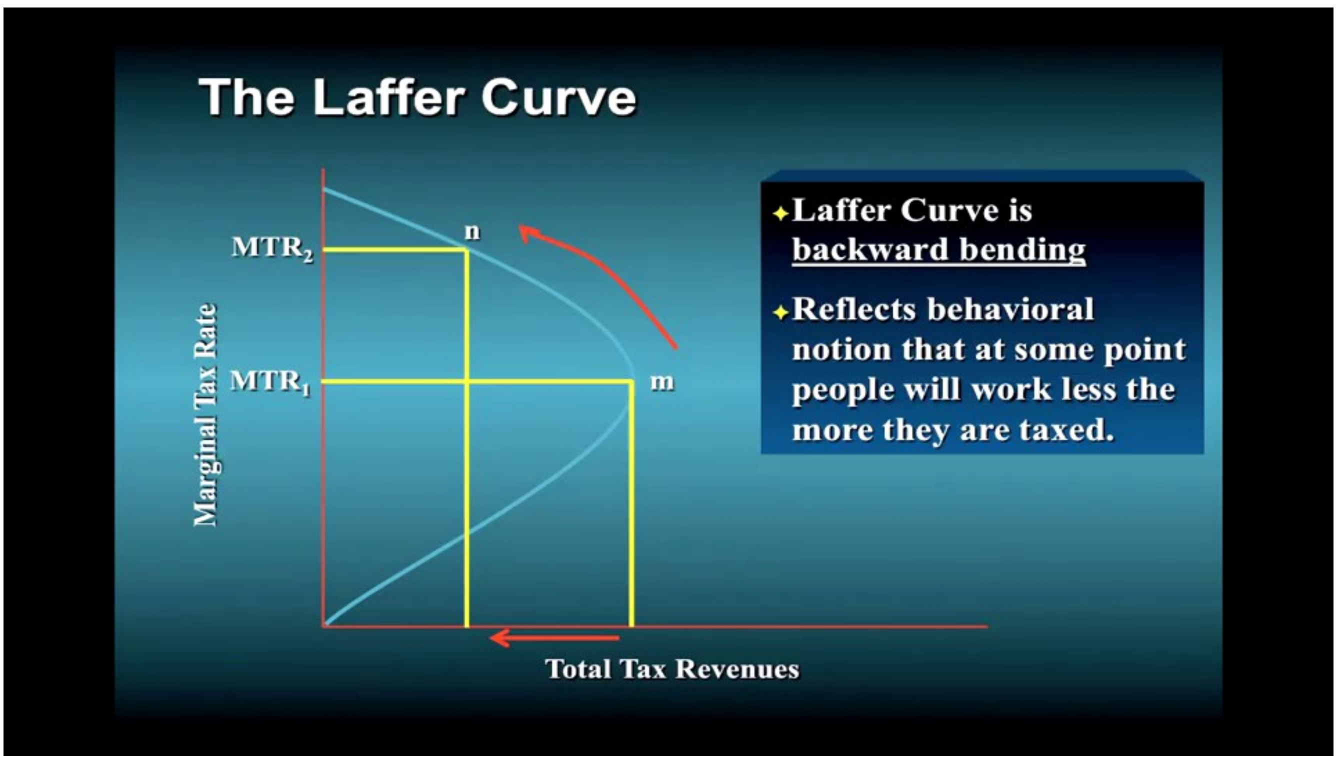
- The supply side approach looks similar to the 1960s Keynesian tax cut.
- Supply siders did <u>not</u> agree that such a tax cut would necessarily cause inflation.

A Behavioral Difference

- Theory: People will work harder and invest more if they were allowed to keep more.
- Presumed Result: Increase amount of goods and services our economy can produce by pushing out the supply curve
- Ergo: “Supply side” economics.



P
AS'
AS
P'
P
AD'
Q
$Q^{P'}$
Q^P



The Laffer Curve
MTR₂
n
MTR₁
m
Marginal Tax Rate
Total Tax Revenues
Laffer Curve is backward bending
Reflects behavioral notion that at some point people will work less the more they are taxed.

The Reagan Tax Cut

- Assumed economy was on the backward bending portion of the Laffer Curve
- Implication: A tax cut would <u>increase</u> total tax revenues.
- Based on this assumption, it moved forward with one of the largest tax cuts in American history.

Reaganomics In Action

- Corporate tax rate cut 25%.
- Top marginal tax rate fell from 50% to 38%.

Key Point

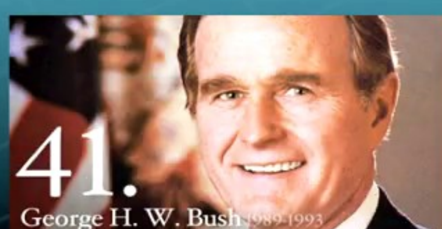
Deregulation of everything from monopoly and oligopoly to pollution and product safety was designed to shift aggregate supply curve out.

Did Supply Side Experiment Work?

- Significant declines in inflation and interest rates.
- A then record-long peacetime expansion.
- Full employment.
- BUT budget and trade deficits ballooned.

The "Twin Deficits" and President Bush

- The Twin Deficits deeply concerned Reagan's successor George Bush.
- The budget deficit jumped over $200 billion at the midpoint of his term in 1990.
- The economy began to slide into recession.



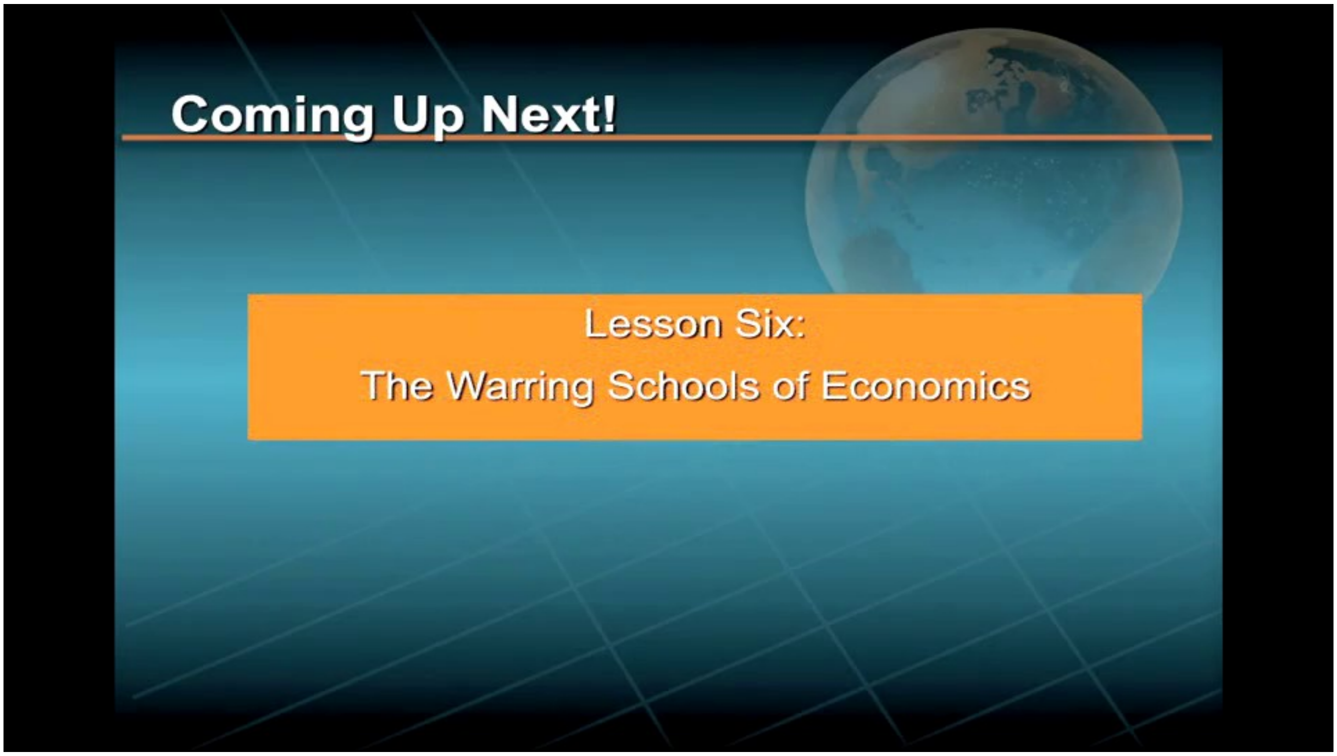
New Classical Economics in Action

- To Keynesians, the 1990 recession would have called for expansionary fiscal and monetary policy.
- In the Bush White House, Ronald Reagan's Supply Side advisors had been supplanted by a new breed of "New Classical" economists.
- They replaced "adaptive expectations" with a new theory of "rational expectations" and rejected short-run Keynesian solutions.

THE POWER OF MACROECONOMICS

Professor Peter Navarro
University of California-Irvine

END OF LESSON FIVE


Coming Up Next!
Lesson Six:
The Warring Schools of Economics