**Supply-Side Economics: Harding to Reagan (Course Number: 400)**

**Instructor: Raymond J. Keating**

**Session One:**

**Supply-Side Economics: Principles, Policies and Theory**

**Supply-Side Economics: The Foundations**

by Raymond J. Keating

**Introduction: Why Did You Land on the Supply-Side?**

So, how did I wind up as a supply-side economist?

Careers are chosen for a variety of reasons. Often, just a few isolated moments in time – some big, others seemingly small – can set people on certain paths. As I think back, two points in my formative years of education helped guide the journey to becoming an economist – specifically, a supply-side economist.

The first actually happened in an eighth grade class. My teacher raised the question: Why is the United States the world’s leading economy? She went on to rule out an assortment of possibilities, noting that there were other nations with more people, with more land, with greater natural resources, with arguably better education, and so on. So, what was the reason then? The teacher admitted that she did not know. To her, it was a mystery. That was the first real economics problem presented to me, and, since I recall it all these years later, the lack of an answer from my teacher obviously nagged at me.

The second moment occurred in my third year of college. I previously had taken a couple of economics courses, but they failed to spark any real interest or passion. Then I took an economics class with Dr. John Arnez at the small college I attended (St. Joseph’s College on Long Island).

Since this was early 1984, the U.S. was in the midst of a dramatic economic renewal. After suffering through the dismal stagflation (i.e, the combination of slow economic growth or even recession, and high inflation) of the 1970s and very early 1980s, the economy was now growing robustly and inflation was retreating. Dr. Arnez concisely noted how dramatic this reversal was, given that most economists had been arguing that the U.S. would just have to learn to live with a slow economy and high inflation. He went on to note that it was a new group known as supply-side economists who offered policy solutions – mainly at the time, lower income tax rates, deregulation, and sound money – while the Keynesian economists who had largely dominated the economics discipline since the 1930s had no answers. Dr. Arnez labeled this “amazing.”

This lesson seized my interest. Supply-side economics had answers that made a real difference in the lives of people. I was hooked.

From there, I went on to read the important, early supply-side tomes, added economics as a second major, wrote an undergraduate thesis on supply-side economics, briefly worked for and learned from Jude Wanniski (who played a key role at *The Wall Street Journal* in communicating supply-side ideas in the earliest days of the movement in the 1970s), and earned an MA in economics at New York University. I’ve worked in the public policy arena, as a newspaper columnist, a book author, and an adjunct professor since the late 1980s, with my thinking rooted in supply-side economics.

**The Essence of Supply-Side Economics**

Economist John Maynard Keynes (1883-1946) once declared: “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist.”

Unfortunately, from a supply-side economics perspective, Keynes is the defunct economist who enslaved many economists, academics, elected officials and other policymakers, the media, and Wall Street since the publication of his book *The General Theory of Employment, Interest and Money* in 1936. His influence lasted into the 1980s, and in various political and economic circles, even to this very day.

The key point from Keynes in his *General Theory* was his introduction of “the notion of aggregate demand as the sum of consumption, investment, and government spending; and because it showed (or purported to show) that full employment could be maintained only with the help of government spending.”[[1]](#endnote-1) In effect, Keynes – or at least, the Keynesian school of economic thought that Keynes gave birth to – removed prices and incentives as the key factors directing and driving the economy, and replaced them with aggregate demand.

This emphasis on aggregate demand as being the driving force of the economy results in economic policymaking focused on cranking up consumer and government spending, with a particular emphasis on government trying to fine tune the economy, with the classic Keynesian case being the government resorting to deficit spending to boost a sagging or shrinking economy.

This aggregate demand and government-centered Keynesian view of the economy certainly has had substantive critics over the years. However, perhaps no other school of economics so audaciously revealed the weaknesses of and countered establishment Keynesian thought and policy as has supply-side economics.

Supply-side economics has been attacked and caricatured by its opponents over the years. In actuality, though, supply-side merely brings the economics discipline back to its microeconomic roots. While Keynesian economics largely concerns itself with government attempts at fine tuning demand and the economy, supply-side economics emphasizes individual economic decision-making and how government policies impact those decisions.

As for a concise definition of supply-side economics, I wrote the following in the June 1995 edition of *The Freeman: Ideas on Liberty* magazine (published by the Foundation for Economic Education): “Supply-side economics has been defined and ill-defined many times over the past two decades. Often, it seems that supply-siders themselves fail to agree on a definition. Economist Norman Ture cut through much of the morass surrounding supply-side economics, compactly summarizing the subject as follows: ‘Supply-side economics is merely the application of price theory—so-called “microeconomics”—in the analysis of problems concerning economic aggregates—so-called “macroeconomics.”’ Though brief, Ture’s statement captured the essence of supply-side economics. I would expand the definition of supply-side economics a bit to the following: *Supply-side economics places supply over demand in the hierarchy of economics, and therefore deals with enhancing economic production, efficiency, and growth within the context of the marketplace; largely—but not exclusively—focusing on relative prices, such as incentives for working, saving, investing, and risk-taking.* While supply-side tax policy has been highlighted for the past two decades, the supply-side school’s purview is much wider.”

In summary, supply-side economics is built on the following tenets:

*• Incentives matter.* Individuals naturally respond to incentives. For example, the relative prices, or costs, of consumption versus investment, or risk avoidance versus risk taking, influence the behavior of individuals, families, entrepreneurs, investors, and businesses.

*• Markets work.* The free market provides clear incentives – through price and profit signals – resulting in resources being allocated to their most efficient and beneficial uses. So, while supply-side economics emphasizes production (see next bullet), it is production within the context of the free market. In order to be of value, production must meet or create a demand. After all, the end point of the entire economic process is consumption.

*• Supply comes before demand in the economic process.* There are two aspects to the idea that supply takes precedence over demand in the economic hierarchy.

First, in the marketplace, one must supply a marketable good or service before one can legitimately demand or consume. That is, as the 19th-century supply-side economist Jean-Baptiste Say (1767-1832) noted, “products are always bought ultimately with products.” One must supply something in order to be able to exchange to meet one’s own needs and desires. Or more plainly, you can’t get something for nothing.

Second, supply creates demand. For example, no general demand existed for televisions, home computers, or most other products or services, until someone invented and improved upon such products and services. “Supply creates demand” or “supply creates its own demand” often is referred to as “Say’s Law.”

*• Since supply comes before demand, the engines of economic growth—working, saving, investing, risk taking, innovating, inventing, and creating—are all supply-side endeavors.* Economic growth can only occur through a boost in resources used for production purposes and/or greater efficiencies, productivity, innovations, and inventions.

*• The entrepreneur – not the government – drives the economy.* Supply-side economics recognizes the critical economic role played by the entrepreneur. As the source of innovation, of new and improved goods and services, of new businesses, and of entirely new industries, the entrepreneur serves as the ultimate source of economic growth.

Yet, the pristine, statistical models that many economists have come to rely on are unable to account for the entrepreneur. How does one plug into an input-output econometric model the often-revolutionary effects brought about by entrepreneurs? So, the importance of the entrepreneur might be acknowledged, to varying degrees, by assorted economists, yet many of these same economists practically leave the entrepreneur out of their explanations of how the economy functions. Does the entrepreneur carry any significance when the Keynesian emphasis is on aggregate demand? The answer obviously is no.

Supply-side thinker George Gilder observed: “Economic recovery depends on the resurrection of entrepreneurs. This resurrection cannot fully and durably occur until the ultimate arbiters of economic policy—the economists—resurrect entrepreneurship in their own influential theories. The contrary vision of capitalism without capitalists springs in part from a fundamental error of economic thought, drastically overrating the importance of physical capital formation and other quantitative measures of economic activity and drastically underestimating the decisive and controlling importance of entrepreneurial creativity.”[[2]](#endnote-2)

Supply-side economics, given its emphasis on supply and the free market, restores the entrepreneur as a central player in the economy.

**Policy Principles Rooted in Supply-Side Economics**

Once one understands the foundation upon which supply-side economics rests, then supply-side economic policies should follow quite clearly.

Various supply-siders over the years have argued that supply-side economic policies fall under or are driven by two “policy levers.”

The first is the fiscal lever – that is, broadly encompassing tax, regulatory, and spending measures geared toward establishing a pro-growth economic environment. The second is the monetary lever – that is, monetary policy meant to establish price stability upon which an economy can function and flourish.

It is very important to understand that under the supply-side economics model, economic growth and price stability are not at odds with one another, but are actually complimentary. After all, the most accurate definition of inflation remains “too much money chasing too few goods.” Therefore, economic growth, or the production of more goods and services, is anti-inflationary.

*The Fiscal Lever*

The following general policy prescriptions are rooted in supply-side economics:

**• Low marginal tax rates.** Marginal tax rates—i.e., the tax rate on the next dollar of income earned—influence economic decisions. For example, the marginal tax rate helps determine the relative price of work vs. leisure, investment vs. consumption, risk taking vs. risk avoidance, and so on. Naturally, therefore, supply-side economics places significant importance on reducing marginal income tax rates in order to boost incentives for working, investing and risk taking.

It’s important to note that given the supply-side recognition of the central role played by entrepreneurs in our economy, low tax rates are not just about income from wages, salaries and business earnings, but income from investment as well. Entrepreneurship is dependent upon investment. That is, entrepreneurs need financial capital to start up and build their businesses. Therefore, capital gains taxes (i.e., taxes on the gains in the value of investments) are particularly destructive to entrepreneurship as they reduce the returns on engaging and investing in entrepreneurial ventures.

In addition, supply-side recognition that supply comes before demand in the economic order leads to a preference for taxing consumption rather than production. This also makes sense given that consumption is the eventual end point of all economic activity, and serves as the most logical point in the economic process to reflect the total cost of government. Of course, as is the case with all taxes, taxing consumption too heavily most assuredly restrains an economy.

In the end, a low-rate, consumption-based tax makes the most sense from a supply-side economics perspective. Debates exist, though, within supply-side circles as to whether a low, flat income tax or a national retail sales tax makes the most sense.

**• A light regulatory burden.** In terms of its effects on the economy, regulation is simply another form of taxation. Regulations raise the costs of and create disincentives for investment and entrepreneurship, and thereby restrain economic growth and job creation. In turn, the wages and incomes of workers and families suffer. Also regarding incentives, as public choice economics has made clear and supply-side economics is in agreement, it is important to keep in mind that elected officials have a much greater incentive to impose regulations as compared to increasing taxes, since voters often react poorly to higher taxes while regulatory costs remain largely hidden from consumer eyes. Politicians can take credit for dealing with a problem – actual or perceived – and then leave businesses to deal with the costs of such regulation. That is a powerful incentive to regulate. Quite simply, as is the case with tax rates, supply-side economics focuses on keeping the regulatory burden as low as possible.

**• Small, limited government.** Supply-side economics is sometimes criticized for not being adequately concerned about government spending and budget deficits. In fact, under supply-side economics, budget deficits are a secondary concern. The primary emphasis is on the total size of government. That is, what are the total resources being diverted from more productive private-sector ventures to less productive government endeavors, whether through borrowing or taxing?

The total size of government matters from a supply-side perspective. Government operates under an abysmal set of incentives. Without the disciplines of prices, profits, losses, and private ownership, government is driven by political incentives. For example, again as public choice economics has shown and taught supply-siders, the incentives in government include spending other people’s money far less wisely than when people spend their own earnings; increasing subsidies, programs and spending on behalf of special interests; and both elected officials and their appointees seeking larger budgets, more staff and increased power. In the end, the incentives at work in government point to resources being used far less efficiently, with economic growth suffering accordingly.

On the secondary level, the relative mix of how government is then financed should be determined by essentially two factors:

1. The relative economic costs of borrowing versus taxing must be considered. For example, lower taxes and a larger short-term budget deficit may carry lower economic costs as compared with higher taxes and a lower budget deficit. Particularly worth noting is the fact that taxes directly impact the costs of working, investing, and risk taking, while the impact of federal budget deficits on such costs, through interest rates, is at best precarious. However, as illustrated after the 2008 economic crisis, budget deficits were driven so high, due to massive government spending levels, that risks increase for future tax increases. As for budget surplus scenarios, supply-side economics raises questions when a surplus signals that the tax burden is too high, and when a surplus boosts the opportunity for government to increase spending.
2. What exactly is being financed must be considered. For example, it might make sense to finance capital projects through borrowing, paid off over the life of the asset, as opposed to government borrowing to cover non-capital spending.

Of course, in the long run, all government expenditures are eventually paid for with taxes and fees (or through inflation). But the mix, timing, levels, and types of taxation help determine the size and growth of the economy.

**• Strong property rights.** Most economists understand the importance of private property rights as encouragements to invention, innovation, improvement and investment. That is, property rights are about incentives. One of the fundamental duties of government is to protect property – both tangible and intellectual property – in order to provide a foundation for economic growth.

Nobel Prize winning economist Douglass C. North has made clear the importance of property rights. He and Robert Paul Thomas highlighted the importance of property rights at the open of their book *The Rise of the Western World*, observing: “The affluence of Western man is a new and unique phenomenon. In the past several centuries he has broken loose from the shackles of a world bound by abject poverty and recurring famine and has realized a quality of life which is made possible only by relative abundance… Efficient economic organization is the key to growth; the development of an efficient economic organization in Western Europe accounts for the rise of the West. Efficient organization entails the establishment of institutional arrangements and property rights that create an incentive to channel individual economic effort into activities that bring the private rate of return close to the social rate of return.”[[3]](#endnote-3)

And in his *Structure and Change in Economic History*, North made the case that “the Industrial Revolution was an acceleration in the rate of innovation” due to “better specified property rights,” which raised “the rate of return on innovating.”[[4]](#endnote-4) He later went on to show and explain that “throughout man’s past he has continually developed new techniques, but the pace has been slow and intermittent. The primary reason has been that the incentives for developing new techniques have occurred only sporadically. Typically, innovations could be copied at no cost by others and without any reward to the inventor or innovator. The failure to develop systematic property rights in innovation up until fairly modern times was a major source of the slow pace of technological change.”[[5]](#endnote-5) North added that “a systematic set of incentives to encourage technological change and raise the private rate of return on innovation closer to the social rate of return was established only with the patent system… More important than patent law per se is the development and enforcement of a body of impersonal law protecting and enforcing contracts in which property rights are specified.”[[6]](#endnote-6)

Again, it’s all about incentives, as supply-side economics emphasizes.

**• Free trade.** From a supply-side point of view, eliminating international barriers to trade lowers costs, opens up markets and opportunities, enhances incentives for production, boosts competition, improves quality, reduces consumer costs, and expands consumer choices.

Free trade captures the benefits of what economists call “comparative advantage,” thanks to the early-19th-century economist David Ricardo (1772-1823), who built on the idea of “absolute advantage” from Adam Smith (1732-1790). Quite simply, comparative advantage illustrates that individuals boost economic prosperity by producing the goods and services they are most efficient at producing, and then trading to acquire other goods and services they need and want. Indeed, even if an individual holds an absolute advantage in a host of endeavors, it still makes sense for him to focus on the area where he holds a comparative advantage, then trading with others.

A clear example helps to drive home the idea of comparative advantage. A doctor may not only be a great surgeon, but also an excellent computer operator. However, the surgeon still hires an office staff to handle his computer operations because he holds a comparative advantage in terms of his surgical abilities. An exchange, or trade, occurs between the surgeon and the office workers. The doctor prospers, and so does his office staff.

This is how a market economy works, with free trade merely stretching these benefits across international borders. Again, from a supply-side perspective, incentives to work, invest, and start up or expand a business – that is, to boost production and growth – are enhanced via free trade policies of keeping governmental costs (i.e., taxes and regulations) related to trade low.

*The Monetary Lever*

A healthy economy depends upon sound money. Price instability and inflation are monetary phenomena that increase the risks and costs of saving, investing, and risk taking. Sound money – that is, knowing that a unit of currency will maintain its value months, years, and decades from now – is a necessary foundation upon which businesses and investors can plan, and an economy can grow.

In the supply-side view, the only objective of monetary policy should be price stability, rather than the current dual mandate imposed on the Federal Reserve of low unemployment and stable prices. The question is how to achieve price stability?

**• Anchored, disciplined monetary policy.** Supply-side economists look for monetary policy to somehow be anchored to market indicators of the supply and demand for money.

Anchoring the dollar to gold – as was the case, to some degree, from the end of the 1870s to the late 1960s – often is cited as a means to price stability. The concept is rather straightforward. When the central bank produces too much money, the demand for and price of gold rises; and when too little money is supplied to match demand, the demand for and price of gold falls. Gold provides a market indicator of monetary policy.

Some supply-siders call for a gold price rule, whereby the Federal Reserve would target a certain gold price range, and vary monetary policy accordingly (e.g., price of gold goes above the targeted range, then tighten policy; if the price drifts below the target, then loosen monetary policy). Some supply-siders call for a return to a classical gold standard, while others look to link the dollar to a basket of commodities. In the end, the point is to establish a market-based discipline by which to guide monetary policy. Without such discipline, government runs monetary policy according to the whims and often-dubious economic theories of central bankers.

**The Intellectual Roots of Supply-Side Economics**

Given that the term supply-side economics did not come into existence until the late 1970s, and that the supply-side economics movement did not emerge until earlier in the same decade – largely in reaction to the failure of Keynesian economics at the time – how deep do the intellectual roots of supply-side economics run?

The answer is that they run back to the dawn of modern-day economics with Adam Smith and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), and Jean-Baptiste Say and *A Treatise on Political Economy* (1803).

For example, in his *Wealth of Nations*, Smith favored proportional taxation (or a flat tax), as opposed to progressive taxes. He wrote: “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”[[7]](#endnote-7) Later, he warned against the destructive threat of taxes: A tax “may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and unemployment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so.”[[8]](#endnote-8)

In particular, though, supply-side economics highlights the phrase “supply creates its own demand,” which is known as “Say’s Law,” named after Jean-Baptiste Say. Say’s Law is foundational to the idea that supply comes before demand in the market process, namely, that nothing can be demanded before it is first offered, created, or invented.

Interestingly, though, Say never actually wrote in his *Treatise on Political Economy* that “supply creates its own demand.” Rather, as noted earlier, he observed, “products are always bought ultimately with products.”[[9]](#endnote-9) Say also understood what Keynes did not, i.e., that government manipulation of consumption, or in Keynes’ terms “aggregate demand,” accomplishes nothing. Say pointed out that “the encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.”[[10]](#endnote-10)

But perhaps most interesting is that Keynes – at least before the publication of his book *The General Theory of Employment, Interest and Money* in 1936 – was something of a supply-sider. In a pamphlet published in 1933 titled *The Means to Prosperity*, Keynes wrote the following:

When … I show, a little elaborately … that to create wealth will increase the national income and that a large proportion of any increase in the national income will accrue to an Exchequer, amongst whose largest outgoings is the payment of incomes to those who are unemployed and whose receipts are a proportion of the incomes of those who are occupied, I hope the reader will feel, whether or not he thinks himself competent to criticise the argument in detail, that the answer is just what he would expect,—that it agrees with the instinctive promptings of his commonsense.

Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance, than an increase, of balancing the Budget. For to take the opposite view to-day is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more;—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss.

Keynes’ key points here are supply-side in nature. First, wealth creation enhances national income, and that growth in turn supplies the government with increased revenue. Second, high taxes discourage economic activity, and therefore, reduce or restrain government revenues, and in contrast, lower taxes can encourage economic growth, which boosts government revenue. It’s clearly Keynes talking incentives and price theory. Interesting? Yes. Surprising? Well, no one should be surprised that Keynes before *The General Theory* was a supply-sider, since supply-side economics finds its intellectual roots in the economics prevailing before Keynes published his *General Theory*.

Over the years, there has been some controversy over the saying “We are all Keynesians now.” Some have attributed this to President Richard Nixon and others to free-market economist Milton Friedman. In a July 1998 article, economist Mark Skousen reported: “On December 31, 1965, *Time* magazine put John Maynard Keynes on the cover and quoted Friedman as saying, ‘We are all Keynesians now.’ Later, Friedman said he was quoted out of context. ‘In one sense, we are all Keynesians now; in another, no one is a Keynesian any longer. We all use the Keynesian language and apparatus; none of us any longer accepts the initial Keynesian conclusions.’”[[11]](#endnote-11)

In terms of the intellectual foundations of economics in general, the following should be said: We were all supply-siders before Keynes’ *General Theory*, and after the failure of Keynesian economics, we all should be supply-siders once again.

1. David R. Henderson, “John Maynard Keynes,” *The Concise Encyclopedia of Economics* (Indianapolis, In: Liberty Fund, Inc., 2008, edited by David R. Henderson), pp. 549-550. [↑](#endnote-ref-1)
2. George Gilder, *Recapturing the Spirit of Enterprise* (San Francisco: ICS Press, 1992), p. 165. [↑](#endnote-ref-2)
3. Douglass C. North and Robert Paul Thomas, *The Rise of the Western World* (New York, NY: Cambridge University Press, 1973), p. I [↑](#endnote-ref-3)
4. Douglass C. North, *Structure and Change in Economic History* (New York, NY: W.W. Norton & Company, Inc., 1981), p. 159. [↑](#endnote-ref-4)
5. Douglass C. North, *Structure and Change in Economic History* (New York, NY: W.W. Norton & Company, Inc., 1981), p. 164. [↑](#endnote-ref-5)
6. Douglass C. North, *Structure and Change in Economic History* (New York, NY: W.W. Norton & Company, Inc., 1981), pp. 164-165. [↑](#endnote-ref-6)
7. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Chicago, IL: The University of Chicago Press, 1976), p. 350 (Book V). [↑](#endnote-ref-7)
8. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Chicago, IL: The University of Chicago Press, 1976), p. 351 (Book V). [↑](#endnote-ref-8)
9. Jean-Baptiste Say, *A Treatise on Political Economy* (New York: Augustus M. Kelley Publishers, 1971), p. 161 [↑](#endnote-ref-9)
10. Jean-Baptiste Say, *A Treatise on Political Economy* (New York: Augustus M. Kelley Publishers, 1971), p. 139. [↑](#endnote-ref-10)
11. Mark Skousen, “Milton Friedman Ex-Keynesian, The Freeman: Ideas on Liberty, July 1998. Skousen quotes Friedman from the following: “Why Economists Disagree,” *Dollars and Deficits* (New York: Prentice-Hall, 1968), p. 15. [↑](#endnote-ref-11)