Supply-Side Economics

Macroeconomics

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Supply-side History

- **François Quesnay and the physiocrats:**
  - **Around the year 1750.**
  - **Emphasized the importance of property rights in a market economy**
  - **Argued that excessive taxation diminishes output**
  - **Argued that high tax rates:**
    - **Kill growth.**
    - **May diminish tax receipts, whereas lowering tax rates may result in such rapid growth as to increase tax receipts.**

History, continued

- Adam Smith in the *Wealth of Nations* (1776) writes that taxes reduce the incentive to work and firms to employ.
- Jean Baptiste Say (1821) argued:
  - "high taxes impoverish the individual without enriching the state", and
  - high taxes are "economic suicide".
- Karl Marx in *Das Kapital* (1867) writes:
  - Over-taxation is a principle in Europe

Redistribution

- **Keynes claimed Malthus (ca. 1820) as his logical predecessor. Malthus feared short-run inadequate demand as a result of over-saving:**
  - **Profits go to owners of capital (capitalists).**
  - **The capitalists are rich, therefore tend to save (I.e., they have a lot of discretionary income).**
  - **As a larger and larger portion of income goes to the capitalists, consumption falls.**
  - **Deficient demand results, leading to widespread unemployment.**
- **Solution: redistribute income from the rich to the poor.**

Mundell

- **Robert Mundell created modern supply-side economics in a single knock-out paragraph at the end of a monograph published in 1971, then never pursued his idea in print.**

About Mundell

- By 1963, Kindelberger of MIT called him "the foremost international economist of his generation." (He was barely 30 years old then.)
- He extended Keynesian economics to the open economy.
- He discovered classical economics and the long run in the late 1960s, and moved to the University of Chicago to learn more.

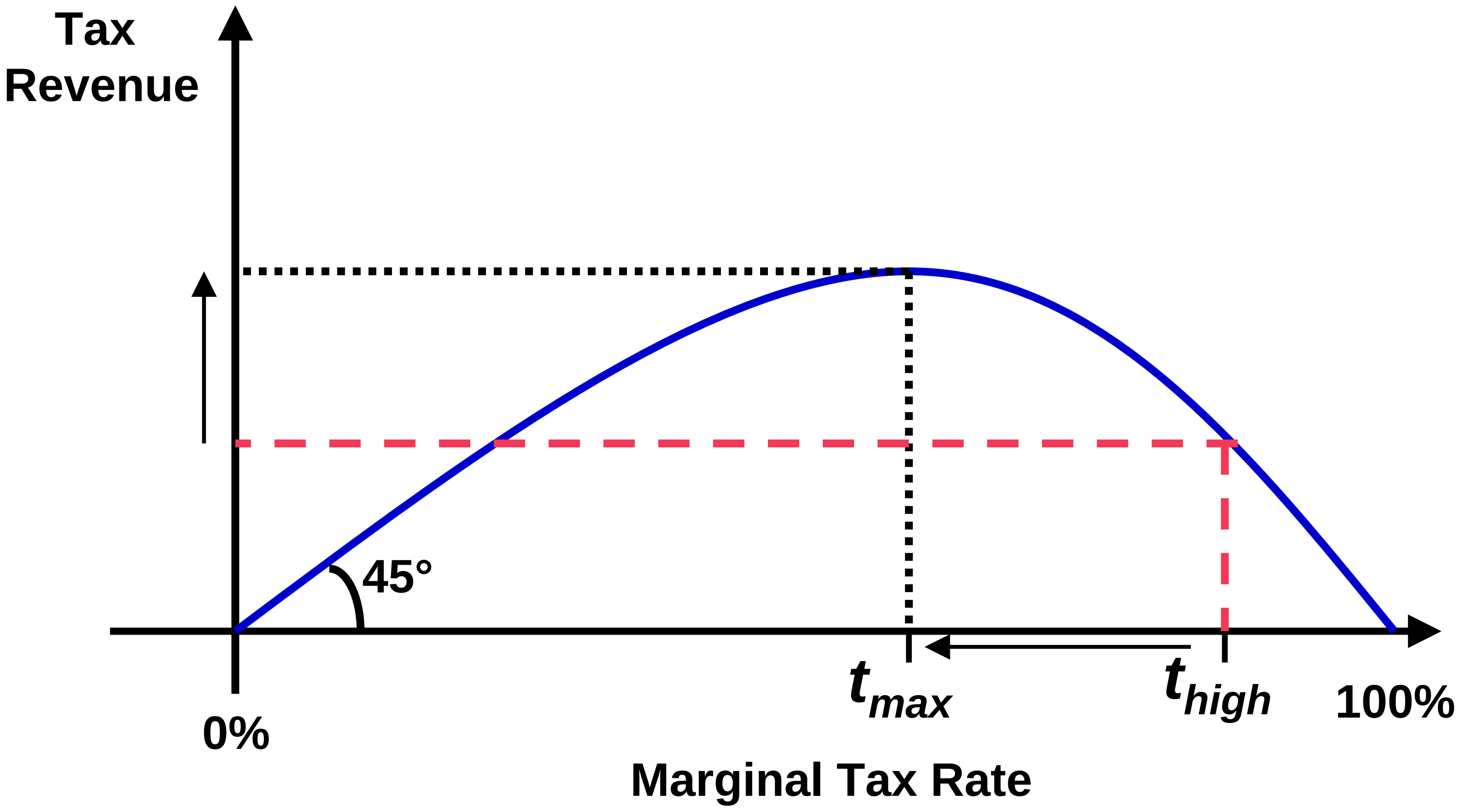
About Mundell, continued

- **Before he was 40, he completely reconstructed the modern theories of:**
  - **Flexible vs. Fixed Exchange Rates**
  - **International Asset Market Theory**
  - **Flight of Funds Theory**
  - **The Monetary Approach to the Balance of Payments**
  - **Formal Models of Money Creation**
  - **Deficit Finance**
  - **External Imbalance**
  - **Monetary Interdependence**
  - **Inflation**

Arthur Laffer

- **BA, Yale, MBA and PhD from Stanford, 1972**
- **Went to Chicago in 1969 as an ABD and works with Mundell. Calls Mundell "a genius."**
- **Whereas Mundell deliberately avoids the limelight, Laffer wants fame. Uses his contacts at Chicago and Stanford to become President Nixon's Chief Economist in OMB.**
- **Mundell visits Laffer in Washington. Laffer introduces Mundell to George Schultz who plays a key role in the Reagan Administration.**
- **The stage is set for Reagonomics.**
- **1974, Laffer draws a curve on a napkin.**

Laffer Curve



Wall Street Journal Connection

- **Jude Wanniski (WSJ reporter) reports on the ideas of Mundell and Laffer in a series of articles beginning in 1974. Interest grows.**
- **March 1976, conference in Virginia. Herb Stein refers to "supply-side fiscalism". Later this becomes "supply-side economics.**
- **1978, Wanniski writes a book called *The Way the World Works*.**

Theory: Incentives Matter

- **Two principles from the first course in economics:**
  - **If you tax something, you get less of it.**
  - **If you subsidize something, you get more of it.**
- **What have we as a society been taxing and subsidizing?**

Incentives (2)

- **We have taxed:**
  - **Income**
  - **Employment and productive effort**
  - **Investment and Saving**
  - **Production of goods and services that the population at large needs and wants, worth more than the cost of production**
  - **(And we've increase regulation of these things.)**
- **Is it any wonder we have gotten less of these?**

Incentives (3)

- **What have we subsidized?**
  - **Unemployment and leisure (unemployment compensation, welfare, redistribution)**
  - **Lack of productivity and contribution to society (welfare, etc.)**
- **Is it any surprise that we've gotten more of these things?**

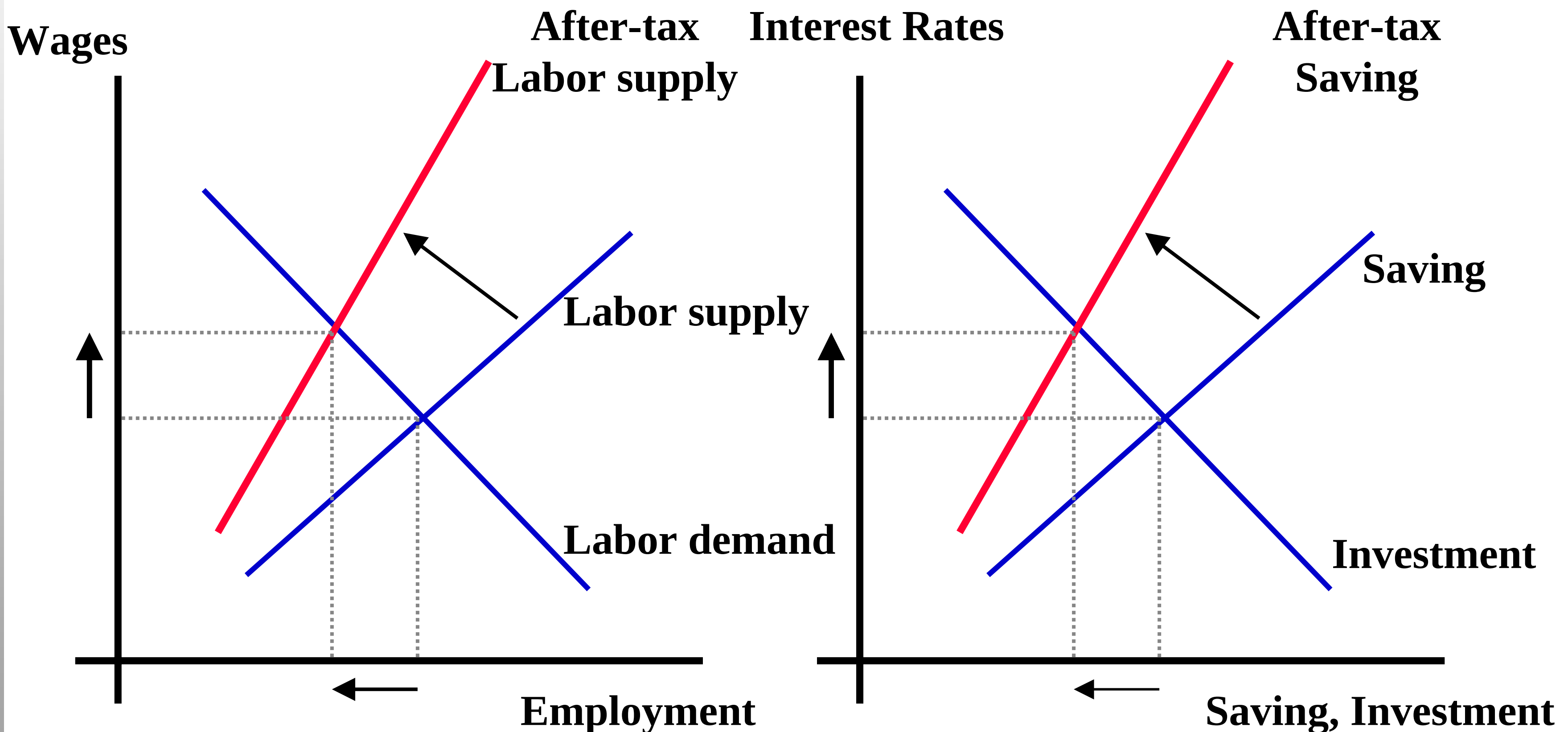
Progressive Taxation

- **Discourages employment at the margin, where the decision is made.**
- **Workers are being penalized for increasing their productivity, working to advance themselves and society.**
- **Of course, any income tax reduces the after-tax wage, reducing labor supply.**

Growth vs. Redistribution

- **Supply-siders argue that the issue is growth vs. redistribution. They argue that they are "growthists" while Keynesians are "redistributionists".**
- **They argue that Keynesians think that society is "zero sum".**
- **Redistribution is destructive to incentives.**
- **Redistribution doesn't work. "The incidence of a tax is not the same as the burden of a tax."**

Tax Wedge


Wages
After-tax
Labor supply
Labor supply
Labor demand
Employment
Interest Rates
After-tax
Saving
Saving
Investment
Saving, Investment