GlobalResearch
Center for Research on Globalization

What Is Supply-Side Economics?

By Dr. Paul Craig Roberts
Global Research, February 04, 2014

Region: USA
Theme: Global Economy

Supply-side economics is an innovation in macroeconomic theory and policy. It rose to prominence in congressional policy discussions in the late 1970s in response to worsening Phillips Curve trade-offs between inflation and unemployment. The postwar Keynesian demand management policy had broken down. The attempts to stimulate employment brought higher rates of inflation, and attempts to curtail inflation resulted in higher rates of unemployment.

In other words, the Phillips curve (named after economist A. W. Phillips) trade-offs between inflation and unemployment were worsening. Each additional job created had to be paid for with a higher rate of inflation, and each reduction in inflation had to be paid for with a higher rate of unemployment.

The Phillips curve met its nemesis in stagflation, a new term that entered economics in the late 1970s. Milton Friedman summed up the demise of the Phillips curve with his article, "More Inflation, More Unemployment."

The appearance of stagflation–simultaneous inflation and unemployment–was a serious problem for Congress, as I pointed out in the late 1970s in an article in The Public Interest, "The Breakdown of the Keynesian Model." Simultaneous inflation and unemployment meant that the federal budget would soon be out of control. In those days Congress actually worried about such an outcome.

The Keynesian economic establishment could offer Congress no solution other than an "incomes policy." An incomes policy was wage and price controls. Inflation would be controlled by suppressing wages and prices, while expansionary monetary and fiscal policies boosted aggregate demand to raise employment. Even Congress understood that aggregate demand could not rise if wages were suppressed.

Congress looked for a different solution, and I, being on the scene as a member of the congressional staff, gave them the solution. In Keynesian economics monetary and fiscal policies only affect aggregate demand. If these policies were expansionary, aggregate demand increases, thus boosting employment and inflation. If these policies were restrictive, inflation and employment would fall with consumer spending. The fault in Keynesian theory and policy was the assumption that fiscal policy had no impact on aggregate supply.

I was able to explain to members of Congress, both Democrats and Republicans who were concerned about stagflation, that some forms of fiscal policy directly increase or decrease aggregate supply. High tax rates mean that leisure is cheap in terms of forgone current earnings–thus there is less labor supply–and current consumption is cheap in terms of foregone future income streams–thus less savings for investments. Keynesian demand

management had run into trouble, because the high tax rates on income reduced the response of supply to demand stimulus. Thus, prices rose instead of output.

The solution, I said, was to reduce the marginal income tax rates across the board. This would increase the responsiveness of supply to demand and cure stagflation.

Both political parties listened. In the House it was the Republicans who took the lead–Jack Kemp and Marjorie Holt. In the Senate, Republicans Orrin Hatch and Bill Roth stepped forward. However, in the Senate the lead was taken by Democrats, especially Russell Long, chairman of the Senate Finance Committee, Lloyd Bentsen, chairman of the Joint Economic Committee of Congress, and my Georgia Tech fraternity brother, Sam Nunn.

As a result of Rep. Jack Kemp being the first congressional spokesman for a supply-side policy and President Reagan's adoption of the policy, supply-side economics is associated with Republicans. However, Republicans almost lost the issue to Democrats. The first official government endorsement of supply-side economics was in the late 1970s by the Joint Economic Committee of Congress under the chairmanship of Democratic Senator Lloyd Bentsen of Texas.

The Joint Economic Committee under Senator Bentsen's leadership put out Annual Reports two years in a row calling for a supply-side policy. As the presidential election approached that put Ronald Reagan in the White House, the majority Democrats in the Senate had a meeting to decide whether to pass the supply-side tax rate reductions prior to the presidential election, thus pulling the rug out from under Reagan on his main plank. The Senate Democrats were inclined to move forward with the tax rate reductions, but the Senate Majority Leader convinced them that it would look like an endorsement of Reagan over their own party's candidate (Jimmy Carter). The Senate Majority Leader said that immediately after the election, the Democrats would take control of the issue and pass the marginal tax rate reductions. The great surprise of the election was that the Democrats lost control of the Senate.

There was more opposition to Reagan's tax bill from Republicans than from Democrats. Republicans believed that budget deficits ranked with the Soviet threat and were more willing to raise taxes than to reduce them. The Republican opposition was so strong that I had a hard time getting the tax bill out of the Reagan administration so that Congress could vote on it. In those days the great bogyman for Republicans was budget deficits, and deficits were what Treasury's projections showed. Although the Treasury was, for the most part, committed to the President's policy and believed that some part of the lost revenues from marginal tax rate reduction would be recovered, which is also what Keynesians believed, the Treasury's revenue forecast was based on the traditional static revenue model that every dollar of tax cut would lose a dollar of revenue.

OMB director David Stockman and his economist Larry Kudlow covered up the revenue loss by assuming a higher rate of inflation. In those days the income tax was not indexed for inflation. Nominal income gains pushed taxpayers into higher tax brackets. The higher was inflation, the higher was nominal GDP and tax revenues. In order to raise the revenue forecast, Stockman only needed to raise the inflation forecast.

Senate Democrats complained to me that they were willing to cooperate with Reagan on the tax bill, but were being cut out. Sam Nunn, who had got "Reaganomics" passed in the

Senate before Reagan was elected, only to have it nixed by President Carter, told me that no one in the Reagan administration had ever spoken to him or sought his support.

The White House chief of staff, James Baker, wanted a Republican "victory," and proceeded to pick a fight with the Democrats who were willing to support President Reagan's policy. I told Jim Baker that he was making a strategic mistake. By cutting out the Democrats, he was setting the policy up for criticism that would create the perception of failure. I told him that Stockman had hidden the deficit by over-estimating inflation, a ploy that contradicted the logic of our policy. If our policy was correct, inflation would be less than Stockman's forecast. The tax revenues would not materialize, and the Democrats, cut out of the action, would seize on the deficits and pay the White House back for cutting them out of any credit for the new policy. (My prediction came true. Democrats, inured to deficits by decades of Keynesian demand management, suddenly became as rabid about budget deficits as Republicans.)

If I had known then just how corrupt politics was, I would have thought twice before warning Baker that the hidden deficits would be used to discredit the policy even if the policy cured stagflation. Baker was allied with George Herbert Walker Bush, Reagan's VP, and the fight was on from day one for the succession to Reagan. Kemp was in the forefront, because he was identified with Reagan's economic policy, and Bush had called it "voodoo economics." If Baker could make Reagan's policy appear to be successful only because Bush had moderated it, all the better for VP Bush's claim to the succession.

Tip O'Neill, the Democratic Speaker of the House, offered an alternative supply-side tax rate reduction to the administration's bill. Speaker O'Neill's bill had a smaller reduction in marginal tax rates on personal income, but had a superior pro-growth tax reduction on the business side. The House Democrats' bill offered expensing of business investment.

The Reagan administration was too fearful to propose expensing (immediate write-offs) of business investment, and here was the leading Democrat in the nation offering it to them. I told Jim Baker to jump on it, to work out a compromise with O'Neill on the size of the personal tax rate reductions and to give the Democrats equal credit for the policy.

That, I told Baker, would ensure the policy's acceptance and success.

For political reasons Baker was more committed to giving Reagan a "victory" over Democrats than he was to the success of the policy. Baker wanted a headline. I wanted a policy. From Baker's standpoint, if Democrats for political reasons turned against the policy, they would help to create welcome roadblocks to Jack Kemp's challenge to George H.W. Bush for the succession.

Reagan's version of supply-side economics carried the day over Tip O'Neill's version. Deputy Assistant Treasury Secretary Steve Entin prepared a graph comparing the Reagan and O'Neill tax rate reductions. The Democrats' tax cut was initially larger, but Reagan's was better over time. That let Reagan go on national TV, point to the graph and say, "the Democrats have the best bill–if you only expect to live one more year."

The history and explanation of supply-side economics are in my book, The Supply-Side Revolution (Harvard University Press, 1984). Books published by Harvard are peer-reviewed, which means that publication depends on a go-ahead from outside experts. A book that was "voodoo economics" or simply said that "tax cuts pay for themselves" or that "trickle-down

economics works by giving the rich money to spend and some of it will trickle-down to help the poor" will not clear peer review.

Thirty-five to forty years after supply-side economics made its appearance in policy debates the vast majority of Americans, including apparently some economists and public intellectuals, have no idea what it is. For example, on February 1, 2014, Information Clearing House posted Bill Moyers interview of David Simon, "America as a Horror Show." This important interview gets fouled in its opening lines when Simon declares: "Supply-side economics has been shown to be bankrupt as an intellectual concept. Not only untrue, but the opposite has occurred."

Supply-side economics was not relevant to the interview. Yet off the bat Simon destroys the credibility of his interview. Supply-side economics cured stagflation exactly as supply-side economists said it would do. That was its only claim. I know. As Assistant Secretary of the Treasury for Economic Policy, I was in charge.

In 2013 The Supply-Side Revolution, which Harvard has kept in print for three decades, was published in China in the Chinese language. Why would a leading Chinese publisher translate and publish a 30 year old book about a subject that "has been shown to be bankrupt as an intellectual concept?" Why would Chinese economists request a publisher to translate and publish a book about a discredited and useless subject?

Why does Simon, a reporter who was on the Baltimore Sun's city desk covering crime during the Reagan administration, think that he knows anything about supply-side economics?

How can America save itself when its public intellectuals have no idea what they are talking about?

As I am associated with supply-side economics and the Reagan administration, the coterie of Reagan haters will write in to the many sites that post my column with sarcastic comments denouncing me for "again defending Reagan." I am not defending anyone. I am merely stating the facts. Anyone can find the facts. All they have to do is to look. But many had rather shoot off their mouths and demonstrate their ignorance. They can't stand the thought of having one less reason for hating Reagan.

As I am an interested party, let's turn to a non-interested one, Paul A. Samuelson, "the father of modern economics." Samuelson was the doyen of Keynesian economics, America's greatest 20th century economist, and the first American economist to win the Nobel prize. If anyone was harmed by supply-side economics, it was Keynesian economists' human capital. Yet in the 12th edition of his famous textbook published in 1985, Samuelson shows how supply-side policy can cause aggregate supply to increase or decrease, a first for economics textbooks. Samuelson validates supply-side economics in principle and says that its policy impact varies from "modest" to "substantial," depending on circumstances. He also says that in Britain, "the supply side policies appear to have had an unexpectedly large impact, improving both inflation and productivity more than many observers expected."

Is the "foremost academic economist of the 20th century" (New York Times) another trickle-down, voodoo kook like me and Ronald Reagan?

I met Samuelson in his MIT office when I gave the annual State of the Economy address to the combined economic faculties and graduate students of Harvard and MIT sometime in the

1980s. Samuelson had an open mind and could absorb new thinking. At the conclusion of my address, I received a standing ovation. No one in the large liberal audience of professors and graduate students said I was a voodoo economist or an agent for the rich. I have debated in public forums Keynesian economists who are Nobel prize winners, such as James Tobin and Larry Klein. They were always respectful. At a meeting of the Eastern Economics Association, Tobin acknowledged that I was correct.

Supply-side economics dealt with the problem of its time–stagflation. Supply-side economics has no cure for an economy decimated by jobs offshoring and financial deregulation. The problems of today are different. I have made this clear in my book, The Failure of Laissez Faire Capitalism and Economic Dissolution of the West.

The George W. Bush tax cuts have nothing to do with supply-side economics. The Bush tax cuts were nothing but a greedy grab, but they are not a signifiant cause of today's inequality. The main causes of the unacceptable inequality of income and wealth in the US today are financial deregulation and the dismantling of the ladders of upward mobility by the offshoring of manufacturing and tradable professional service jobs. The wages and salaries denied to Americans are transformed into corporate profits, mega-million dollar executive bonuses, and capital gains for shareholders. Financial deregulation unleashed massive debt leverage of bank depositors' accounts, backed up with Federal Reserve bailouts of the banksters' uncovered gambling bets. Neither tax increases nor reductions can compensate for these extraordinary mistakes.

Intelligent people over the centuries have stressed that failure to understand the past endangers the present and the future. Across the American political spectrum policymakers, economists, media, commentators, and the public are ignorant of the past and in denial about the present. Those trying to inform are few and far between, and they are constantly under attack from the very people they are endeavoring to inform.

What is the point of the effort to inform? Is it merely "sound and fury, signifying nothing"?

The original source of this article is Global Research
Copyright © Dr. Paul Craig Roberts, Global Research, 2014

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: **Dr. Paul Craig Roberts**

About the author:

Paul Craig Roberts, former Assistant Secretary of the US Treasury and Associate Editor of the Wall Street Journal, has held numerous university appointments. He is a frequent contributor to Global Research. Dr. Roberts can be reached at http://paulcraigroberts.org

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca