



WHAT IS SUPPLY-SIDE ECONOMICS—AND HOW DOES IT DIFFER FROM DEMAND ECONOMICS?

By Arthur B. Laffer, Ph.D., and Brian Domitrovic Ph.D.

Introduction

Presidents in particular, Congresses almost always, and governments in general stray far from intellectual purity and consistency. It's simply not in their nature to adhere only to one view of how economics works. President Jimmy Carter, for example, was no fan of supply-side economics, and yet did wonders with deregulation (airlines and trucking). President Kennedy was a master tariff and tax-rate cutter, and yet sanctioned public-sector unions. Even President Nixon, who loved wage and price controls, taxes, and tariffs, still dropped the highest "earned" income tax rate to 50% from 70%. No matter these one-off moments of prescience, supply-side economics finally had its day in the Reagan era. Post-Reagan, Clinton was ambivalent, raising the top income tax rate and then under Republican pressure dramatically lowering spending and the capital gains tax rate. However, with Presidents Bush I, Bush II, Obama, and Biden, there was a significant backlash against supply-side economics. This period was followed by an enormous resurgence of supply-side economics under the Trump presidency.

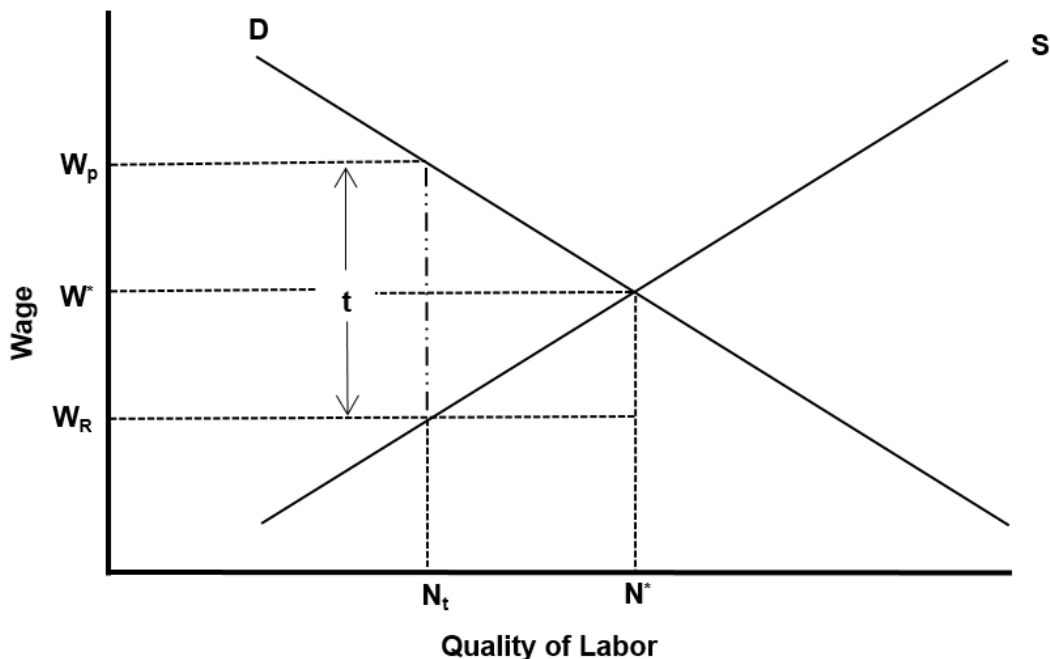
The constituency of supply-side economics does overlap with free-market economics, laissez faire, and conservative ideology, but these other views are not the same as supply-side economics. Supply-side economics is solely about incentives. An uncomplicated version follows:

In terms of taxes, the key postulates of supply-side economics are:

- i.) People work to get paid an after-tax wage to buy goods and services—it's that very personal and private incentive that motivates people to work or to change jobs; the higher taxes are on working, and the higher taxes are on the products workers buy, the less people will work; the supply of work effort is the demand for goods and services;
- ii.) Companies employ workers based upon the employees' total cost including taxes to the company (gross wages paid)—the higher the total cost companies have to pay, the fewer workers companies will hire.

Putting points i.) and ii.) together, a tax drives a wedge between what an employer has to pay a worker gross of taxes and what that worker receives net of taxes. An increase in that tax makes hiring workers more expensive and makes working less rewarding to workers. Employment will fall.

Using the time-tested economics diagram of supply, demand, and taxes, you can quickly visualize what happens to the number of workers employed and wages paid and wages received when a tax is imposed.



Where W^* and N^* are the wage and the number of workers employed, respectively, without tax, and W_R and W_P are wages received, after the tax, by workers and wages paid including tax (t) by employers. N_t is the new lower employment that results from the imposition of tax (t).

Supply-side propositions continue:

- iii.) The supply of savings available to investors depends on the after-tax return paid to savers. The higher the after-tax return, the more savings there will be. People save in order to earn an after-tax return on their savings;
- iv.) Likewise, investors get funds from savers at rates that include taxes in order to earn an after-tax yield on investments. Any tax on the returns to savers and investors will reduce not only the after-tax yield on savings and investments, but investment and savings themselves; again, people do not save or invest to go bankrupt;
- v.) Greater savings and investments increase real wages and the demand for workers. In the same vein, more workers increase the real returns on savings and investment and thus increase the demand for capital.

In short, according to supply-side economics, a country cannot tax itself into prosperity. Nor can a poor country's government spend that country into wealth.

To supply-side economics adherents, tax rates, regulations, government spending, inflation, and trade barriers are all wedges driven between the costs of hiring workers and obtaining capital that employers have to pay and the after-tax wages and after-tax profits workers and savers receive. In addition:

- vi.) Higher tax rates increasingly reduce income, output, and employment, which is the base upon which taxes are levied. Therefore, the higher tax rates are, the more likely it is that further increases will actually reduce tax revenues. At tax rates over 100 percent, there will be no tax revenues.
- vii.) An increase in the supply of goods and services lowers prices, just as any increase in the supply of a product lowers that product's price, while shortages of goods and services push prices higher. Policies that enhance growth also reduce inflation, i.e., there is no trade-off between growth and inflation; there is no Phillips curve.
- viii.) Supply-side monetary policy is also laser-focused on maintaining the integrity and value of the numeraire, i.e. a price rule not a quantity rule (as advocated by monetarists) for monetary policy. Assured price stability enhances growth.

It is essential to consider carefully the incentive effects of all participants in the sequence of supply of and demand for output. In the realm of taxation, this would include income, payroll, property, sales, and death taxes, including tariffs, plus, plus, plus. The impacted incentives would also include the costs borne by taxpayers in complying with taxation and the costs governments incur in collecting taxes. Government does not create resources—when government redistributes resources, it reduces output.

Demand economics postulates the following:

- i.) People work because there are jobs, i.e., demand creates its own supply of workers;
- ii.) Demand, in turn, is driven by government spending, plus investment and consumption, with savings being the difference between what people earn and what they consume;
- iii.) Because savings always equals investment, not enough consumption, i.e., too much savings, reduces income and increases unemployment;
- iv.) To offset the negative effects of too much savings and not enough consumption, governments need to increase aggregate demand by spending more;
- v.) According to demand economics, tax cuts and increased welfare spending for low-income earners adds a boost to the economy. In this world, increasing unemployment benefits counterintuitively is one of the best ways to increase employment.

To increase jobs, demand economists turn to government spending increases and more progressive tax rates. The conundrum for demand economists is that increases in demand also cause inflation. Life as they know it hinges upon figuring out how to balance the pluses of growth with the minuses of inflation. This tradeoff is referred to as the Phillips curve. In their world, increases in goods and services increase the price level of goods and services.

Monetarists to a large extent, and Keynesians to a lesser extent, argue that demand is also driven by changes in the quantity of money. And all changes in the quantity of money are supply-driven, never demand-driven. To them, increases in money initially stimulate real growth, which is then followed by inflation. Again, there is a trade-off between inflation and unemployment.

Starkly put, in demand economics, all changes in output are caused by changes in demand, and all changes in money are caused by changes in supply.

By way of example, to a Keynesian, an increase in government spending puts income (money) in the hands of people who spend it by consuming more. The higher consumption of those who received the increase in government spending creates jobs to supply the additional consumption. The income earners from those new jobs also consume more, thus creating even more jobs, cascading on down the line. In total, the increase in income (GDP) from an increase in government spending is equal to $1/(1-c)$ (called the multiplier) times the increase in government spending, where “c” is the marginal propensity to consume and “s” is the marginal propensity to save: $s = 1-c$. Therefore, higher savings, resulting from a lower marginal propensity to consume, c, leads to lower output. Professor Samuelson famously called this “the savings paradox.” To these people, government can spend an economy into wealth.

If total income isn’t as high as it should be, all government needs to do is increase government spending (G) or redistribute income with taxes and transfers until the appropriate level of total income is achieved.

From the perspective of supply-side economics, there is a glaring contradiction in the above description of Keynesian economics that invalidates the whole model. If a sum is taken from one person, and given to another person, the loss of demand from the first person will be offset by the increase in demand of the second person. There will be no stimulus whatsoever to the economy. Victim Peter spends less while robber Paul spends more.

And then supply-side economics takes this one step further. Why would the first person—the person from whom the sum was taken, i.e., whose taxes were increased—want to earn as much as before? Clearly he wouldn’t. The first person from whom the government is now taking more will be less incentivized to earn income. And if that weren’t enough, the second person who now receives the appropriated sum that the government took from the first person has an alternative source of income other than working, which results in that person’s working less as well. Government transfers actually reduce total output. This is math, not opinion.

To add insult to injury, supply-side economists would also point out that those people receiving the income are often “required” not to work in order to be eligible to receive the payments from the government. In other words, if you work more, we won’t give you the money, and if you work less, we’ll give you more money.

Tax people who work, and pay people who don’t work, and there will be less people working. Je suis content...on a la preuve.

Demand-side economics, which argues that larger government creates a more prosperous economy is precisely the opposite of supply-side economics, which argues that higher tax rates and more government spending reduce output and prosperity. In the extreme, it would be hard to deny that if everyone who worked had to pay 100 percent of their earnings in taxes, and everyone who didn’t work was given everything that there would be no work at all.

But as a final point of differentiation between the two camps of economists that is not based explicitly on taxes but on other incentives, I would be remiss if I did not also address the issues surrounding national security. In this arena the stakes are high and the differences between the two economic perspectives are stark. The supply-side perspective on national security: reward peace with opportunities to achieve enhanced prosperity while being completely prepared to punish aggression with a strong military, e.g. peace through strength. The supply-side formula is a massive defense capability coupled with an equally massive ability to pursue prosperity. In the words of President John F. Kennedy, “The best form of defense spending is always wasted.” Defense spending discourages others from aggression, thus obviating the need to use defense capabilities. The choice should be easy for them to make.