Understanding Supply-Side Economics:
The Principles, the Policies, and the Future

by Raymond J. Keating
Chief Economist
Small Business Survival Committee
and
co-author of
U.S. by the Numbers:
Figuring What’s Left, Right, and Wrong
with America State by State
Introduction

President George W. Bush’s proposal to reduce taxes has re-ignited the economics debate in our nation. Specifically, in his budget address before Congress in late February 2001, President Bush cited the tax cuts of President John F. Kennedy and President Ronald Reagan to support his argument for tax relief today:

Forty years ago, and then 20 years ago, two Presidents, one Democrat, one Republican, John F. Kennedy and Ronald Reagan, advocated tax cuts to, in President Kennedy’s words, get this country moving again. They knew then what we must do now. To create economic growth and opportunity, we must put money back into the hands of people who buy goods and create jobs.

Interestingly, the Kennedy and Reagan tax cuts were firmly rooted in supply-side economics. As for the Bush tax plan, it offers two fundamental supply-side ingredients: 1) replacing the current five-rate personal income tax structure of 15%, 28%, 31%, 36% and 39.6%, with four lower rates of 10%, 15%, 25%, and 33%, and 2) killing death taxes.

The Bush budget document, “A Blueprint for New Beginnings,” made clear that the roots of the Bush tax cut, at least in part, can be traced to supply-side thinking: “The president’s tax plan also recognizes the important role that constructive tax policy plays in generating high rates of long-term growth. Reductions in marginal tax rates encourage greater work effort and provide more inducement to save and invest in business enterprises.”

In addition, on April 10, 2001, The New York Times published an article carrying the title “Back in Business: Supply-Side Economists Regain influence Under Bush.” As a result, we have seen some on the political left attacking supply-side economics, with various conservative and free-market supporters rising in defense. The time is right to review supply-side principles, policies, and history, and dispel mistaken notions, so that we can have an informed debate, and chart a pro-opportunity, pro-growth course for America’s economy as we set sail into the 21st century.
Economist John Maynard Keynes once declared: “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist.”

Unfortunately, the defunct economist that continues to enslave many economists, academics, policymakers, elected officials, the media, and Wall Street today is Keynes himself. While Keynesian economics has long proven a complete failure, with its mistaken emphasis on government fine tuning of the economy (or more specifically, aggregate demand), such thinking continues to hold considerable sway.

The government-centered Keynesian view of the economy certainly has had substantive critics over the years. However, perhaps no other school of economics so audaciously contradicted 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 emphasizes individual economic decision-making and how government policies impact those decisions.

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, and businesses.

- **Markets work.** The free, unfettered market provides clear signals—that assure that resources are 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 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. Indeed, no general demand existed for televisions, home computers, or most other products or services, until someone invented and improved upon such products and services.

- 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, 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 new products, services, inventions, and innovations, the entrepreneur serves as the ultimate source of economic growth.

- 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—knowing that a unit of currency will maintain its value months, years, and decades from now—is the necessary foundation upon which an economy can prosper.

Path to Prosperity: Supply-Side Policies

Once one understands the foundation upon which supply-side economics rests, then supply-side economic policies become quite apparent.

Supply-side policy is driven by two “policy levers.” The first is the fiscal lever—tax, regulatory, and spending policies geared toward establishing a pro-growth economic environment. The second is the monetary lever—monetary policy geared to establish price stability upon which an economy can function and flourish.

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 fiscal policy prescriptions are deeply 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.

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, as 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 cripples an economy.

In the end, a low-rate, consumption-based tax makes the most sense from a supply-side economics perspective.

• **A light regulatory burden.** Regulation is simply another form of taxation—though largely hidden from consumers’ eyes. Regulations raise the costs of investment and entrepreneurship, and thereby restrain economic growth and job creation. In turn, the wages and incomes of workers and families suffer.

• **Small, limited government.** Supply-side economics is sometimes criticized for not being adequately concerned about 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 most. Government operates under an abysmal set of incentives. Without the disciplines of prices, profits, losses, and private ownership, government is inherently wasteful, and therefore, should be quite limited in its duties.

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

The relative economic costs of borrowing versus taxing must be considered. For lower taxes and a larger short-term budget carry lower economic costs as compared with

“Without the disciplines of prices, profits, losses, and private ownership, government is inherently wasteful, and therefore, should be quite limited in its duties.”
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. Without a doubt, supply-side economics does not look kindly on budget surpluses, which signal that the tax burden is too high and the opportunity for government to increase spending is greatly enhanced.

2) A question must be answered: What exactly is being financed? It might make sense to finance capital projects with long lives through borrowing, paid off over the life of the asset.

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

- **Free trade.** From a supply-side point of view, eliminating international barriers to trade lowers costs, expands and opens 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.” 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 free market economy works, and free trade merely stretches these benefits across international borders. Free trade is a win-win scenario.

*The Monetary Lever*

“In the supply-side view, the only objective of monetary policy should be price stability. In turn, a sound currency and stable prices create an environment where investment and the economy can flourish.”

In the supply-side view, the only objective of monetary policy should be price stability. In turn, a sound currency and stable prices create an environment where investment and the economy can flourish. The question is how to achieve price stability?
• Anchored monetary policy. Anchoring the dollar to gold—as was the case, to some degree, from the end of the 1870s to the late 1960s—still serves as the surest path 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 good market indicator of monetary policy.

Some supply-siders call for a gold price rule, where the Federal Reserve targets a certain gold price range, and varies 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). A few others call for a return to a classical gold standard. Either way, 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 Supply-Side Record

The record of supply-side economics has come under considerable assault in recent years, particularly as it relates to supply-side policies in the 1980s. Such attacks have been largely motivated by politics and by those favoring continued government micromanagement of the economy. An honest assessment of the results scores quite favorably in supply-side’s favor.

Tax rate cuts. The prominent periods of supply-side tax policies during the twentieth century—1900 to 1912, 1922 to 1929, 1964 to 1968, and 1983 to 1989—all show above average rates of economic growth (see chart below).
From the early 1870s to 1913, the United States levied no income tax whatsoever. The Civil War income tax was extinguished in 1872 and another income tax lived only for a very brief period in the 1890s before the Supreme Court declared it unconstitutional.

During the early twentieth century when we had no income tax—1900 to 1912—real annual rates of growth averaged 4.5 percent. Over the 1922 to 1929 period, the top individual income tax rate fell from 73 percent to 24 percent. During the period of 1964 to 1968, the top rate was reduced from 90 percent to 70 percent, and during the 1980s, the top tax rate fell from 70 percent to 28 percent. Again, each period registered above-average real rates of economic growth.

“As supply-side economists have always argued, with just a little spending restraint, deficits will fall, not rise, when pro-growth tax cuts are implemented, like reducing the capital gains tax, the estate tax, and general personal and corporate income taxes.”

As it relates to the 1980s, the main criticism consistently levied against supply-side tax cuts is that they created massive budget deficits. In fact, however, as noted in the charts below, reductions in both individual and corporate income tax rates were not accompanied by reductions in tax revenues. Indeed, revenues soared. Too much spending was the source of the
1980’s budget deficits, not tax cuts. This is a critical point to understand today, as some argue against tax cuts in the belief that large deficits will return.

As supply-side economists have always argued, with just a little spending restraint, deficits will fall, not rise, when pro-growth tax cuts are implemented, like reducing the capital gains tax, the estate tax, and general personal and corporate income taxes. Contrary to the economic models relied upon by Congress and the White House, the world and the economy are not static; they are dynamic. Therefore, individuals alter their economic behavior to reflect altered incentives. Boost incentives for working, saving, investing, and risk taking, and in turn, you get more of such activities, which results in faster economic growth, more job creation, a larger tax base, and more tax revenues.

Even the below average real growth rates from 1990 to 1996 (an average of only 2.5 percent) helped reduce the federal budget deficit. Higher-than-average real annual economic growth from 1997 to 2000--averaging 4.5 percent--brought us to the point where we are now experiencing and projecting large budget surpluses. Continued growth will rest, in part, on pushing ahead with supply-side tax changes, building on the 1997 capital gains tax cut which lowered the top rate from 28 percent to 20 percent.

**Deregulation.** Growth during the 1980s also was given a boost by a decline in the overall federal regulatory burden. According to economist Thomas Hopkins of the Rochester Institute of Technology, the real federal regulatory burden was on a steady decline from the late 1970s through 1988 (see chart on the next page). This positive, downward trend, however, was reversed in 1989 and regulatory costs have continued to rise since.
A study by Dr. Richard Vedder (“Federal Regulation’s Impact on the Productivity Slowdown: A Trillion-Dollar Drag,” Center for the Study of American Business, July 1996) estimated that rising regulations between 1963 and 1993 explain almost half of the nation’s slowdown in long-run productivity over that period. That is, annual productivity growth would have been 1 percentage point higher if regulations had remained at 1963 levels. By 1993, GDP would have been $1.27 trillion higher.

In the early months of President George W. Bush’s administration, there were some encouraging signs that the very real costs of regulation were being recognized. If that trend were to continue, the economy would benefit enormously.

**Downsizing government.** The specific impact of downsizing government in the United States is difficult to pinpoint since government has been steadily growing for decades. The economy grew at an average annual real rate of 4.5 percent from 1900 to 1912, after which the size and reach of government grew considerably. From 1900 through 1929, before the even more sizable expansion of government under the New Deal, real average annual rates of growth registered 3.6 percent. Since 1930, real annual growth rates have averaged 3.3 percent. These numbers would seem to indicate that bigger government means slower economic growth.

Dr. Richard Rahn, a board member of the Small Business Survival Committee, has performed more in-depth analyses of the size of government and its effect on economic growth. In 1986, while at the U.S. Chamber of Commerce, Rahn and a group of economists examined the relationship between the total size of government and economic growth in 22 nations. They
estimated that government maximized economic growth when it claimed between 15 percent and 25 percent of GDP. Today, government in the United States gobbles up more than 30 percent of GDP. A more recent study by Rahn and Harrison W. Fox, Jr. (“What is the Optimum Size of Government?” sponsored by the Business Leadership Council and the Vernon K. Krieble Foundation) examined the relationship between economic growth and the size of central governments for the period of 1951 to 1993 for 57 nations. They concluded that growth is maximized when the central government’s share of GDP registered between 10 percent and 15 percent (see chart on the next page). The U.S. federal government captures about 21 percent of GDP.

Even more worrisome is the fact that the U.S. economy is grossly under-performing at its current level of central government spending according to Rahn’s numbers. From 1990 to 2000, U.S. real annual economic growth averaged 3.4 percent, while Rahn’s analysis shows annual average growth rates of 4.2 percent for nations with similar central government expenditure levels.

This raises additional questions about the size of state and local government in the United States, the overall tax structure, the regulatory environment, as well as the costs of an increasingly litigious society—lawyers, the proliferation of frivolous lawsuits, less investment and innovation by business due to the fear of lawsuits, and lavish awards represent a significant deadweight loss to the economy.

Rahn’s analysis clearly supports the supply-side case for far smaller government than currently exists in the United States today.

Free trade. One of the most costly anti-supply-side measures taken this century was the Smoot-Hawley Tariff Act of 1930. As Smoot-Hawley crawled through Congress, it played a major part in the stock market crash of late 1929. Its passage set off a trade war, collapsing international markets, and igniting the Great Depression. In contrast, post-World War II efforts at reducing international barriers to trade have been fairly successful, though much is left to be done.

The chart on the next page traces real U.S. imports and exports since 1929. Due to the scale of this graph, one might get the impression that the drop off in trade after 1929 was not that large. However, between 1929 and 1933, real U.S. exports and imports each dropped by 56 percent. Real exports failed to reach their 1929 levels again until 1946, and real imports in 1944.

“At the dawn of the 21st century, it must be remembered that trade barriers place U.S. businesses, entrepreneurs and employees at a severe competitive disadvantage.”

In contrast, from 1950 to 2000, real U.S. exports increased by better than 1,100 percent, and imports increased by more than 1,800 percent.
At the dawn of the 21st century, it must be remembered that trade barriers place U.S. businesses, entrepreneurs and employees at a severe competitive disadvantage.

**Monetary policy.** Since the final remnants of the dollar’s link to gold disintegrated in the late 1960s (with the gold window officially being closed in 1971), inflation and inflation expectations continue to loom. Of course, inflation expectations reflect themselves in interest rates.

As illustrated in the chart on the following page, inflation, inflation expectations and interest rates, all remained quite low while the dollar was somehow linked to gold until the late 1960s. Once the gold-dollar link was abandoned, each have continued to hover at historically high levels.
While the dollar was anchored to gold in some legitimate way from 1879 to the late 1960s, high-quality corporate bond yields rarely ventured higher than 5 percent. Form 1919 to 1966, for example, Moody’s Corporate Aaa bond yields averaged 3.9 percent. Since the discipline of gold was removed, these yields rarely dip below 7 percent, and averaged 8.8 percent.

Interestingly, though, interest rates failed to jump even when inflation occasionally spiked (usually in time of war) during the gold era. Individuals understood that an inflation flare-up was a temporary phenomenon when monetary authorities were disciplined by gold. Inflation expectations remained low. In the post-gold era, since the late 1960s, significant inflation expectations persist, and with good reason.

Historically high inflation expectations and interest rates have nothing to do with too much growth in the economy or employment, or budget deficits or surpluses, and everything to do with anchorless monetary policy.

Still, in the uncertain post-gold environment, the Federal Reserve’s record under Chairman Alan Greenspan warrants some admiration. After some rocky inflation years from 1987 through 1991, the Greenspan Fed performed admirably from the early 1990s into the late 1990s. In part, that was because Greenspan seemed to be keeping an eye on such market inflation indicators as the price of gold and long-term interest rates when setting Fed policy. However, since apparently abandoning such sound policy guidelines over the past couple of years, unwarranted interest rate hikes have helped to dramatically slow down the economy. This recent shift from sound to misguided policies illustrates the unpredictable nature of monetary policy in the post-gold era.

A Supply-Side Agenda for the 21st Century

After reviewing basic ideas, policies, and results, the supply-side economics agenda for the coming century is clear:

• **Plow expected budget surpluses into pro-growth, supply-side tax reduction.** The federal government’s debt would gradually fall over the years, while investing, risk taking, economic growth and job creation would accelerate.
• In the short run, cut income taxes across the board and eliminate two specific taxes that diminish investing, risk-taking, and entrepreneurship, i.e., the capital gains tax and the death tax. Such a plan would vastly improve the environment for economic growth.

The Bush income tax rate reductions not only need to be instituted immediately, rather than phased in over several years, but they also need to be treated as but a first step to be quickly followed by further cuts in both personal and corporate tax rates.

As previously noted, supply-side economics is not only concerned with marginal tax rates, but with the overall amount of resources the government is draining from the private sector given the incentives for waste in the public sector. The result from performing this type of analysis requires a deep tax cut as well. As noted in the chart on the next page, federal revenues as a share of the economy have approached record levels in recent years, and actually hit a peacetime record high of 20.6 percent in 2000. Whenever federal receipts have approached such lofty levels, the economy has either slowed down considerably or slipped into recession. In fact, the economy was exhibiting a dramatic slowdown in late 2000 and early 2001. Taxes need to be reduced substantially.

• In the end, replace our current messy, counter-productive tax system with a low-rate, simple, consumption-based tax. Either a flat tax or a low-rate national retail sales tax makes sense. Incentives for working, saving, investing, and risk taking would skyrocket, and economic growth would accelerate.

• A massive deregulation effort must be undertaken to boost economic growth as well. This means not only rolling back current onerous regulations, but establishing a system that helps to prevent the imposition and continuation of wrongheaded and costly regulations. This new process needs to include congressional pre-approval of all rules and regulations, sunsetting regulations, and using sound science-based risk assessment and cost-benefit analysis when evaluating possible new or renewal of current regulations.
• Dramatic reductions in the size of government—federal, state, and local—must occur. Privatization, competitive contracting, and cutbacks in and elimination of wasteful programs must be implemented in order to cut government spending and free up resources for more productive private-sector uses. Shifting Social Security, for example, to a system of privately owned and controlled investment accounts would boost individual returns and free up resources for pro-growth, private-sector investments.

• Efforts to tear down trade barriers both at home and in other nations must be stepped up. Indeed, unilateral action on the part of the United States in lowering our own trade barriers would not only benefit U.S. businesses and consumers, but would set a stellar example for the rest of the world.

• Re-linking the dollar to gold would reduce inflation and inflation expectations, and cut interest rates dramatically. The benefits to individuals and businesses are manifest. In addition, as other nations return to gold, exchange rates would stabilize, reducing risks of international investment and trade.

“If the 21st century turns out to be a supply-side century, man’s achievements will only be limited his imagination, not by misguided government actions.”

Despite relentless attacks by opponents, supply-side economics not only makes economic sense, but it works. The supply-side emphasis on incentives, free markets, economic growth, the entrepreneur, and sound money claims a long, honored history.

If the 21st century turns out to be a supply-side century, man’s achievements will only be limited his imagination, not by misguided government actions.

---

About the Author

Raymond J. Keating serves as chief economist for the Small Business Survival Committee. He is the author of hundreds of booklets, studies, and articles. Keating’s latest book is U.S. by the Numbers: Figuring What’s Left, Right, and Wrong with America State by State (Capitol Books, 2000). He also is a weekly columnist with Newsday.

About SBSC

The Small Business Survival Committee (SBSC) is a nonpartisan, nonprofit small business advocacy group with over 70,000 members across the nation. For more information, please visit SBSC’s website at www.sbsc.org.