Supply-Side Economics and Austrian Economics

by Bruce Bartlett

The term "supply-side economics" was coined in 1976 by Professor Herbert Stein of the University of Virginia to describe some of the arguments being put forward at that time, primarily by policymakers, to deal with the twin problems of inflation and stagnation, often called "stagflation." Supply-side economics, therefore, was not and is not a separate school of economic thought, such as Austrian economics or Keynesian economics. Rather, it is a shorthand description for a body of economic policies firmly rooted in the free-market tradition of classical economics, Austrian economics, and other schools. It draws upon such resources to support policies aimed at reducing the size of government and government control over the economy. Thus it has far more in common with Austrian economics than it has in conflict.

The origins of supply-side economics explain much of the confusion about what it is about. It is often identified exclusively as a theory of taxation which says that tax cuts pay for themselves. This is a vast oversimplification. Supply-siders never believed that an overall reduction in taxation would increase the government's revenue, through increased economic activity, nor did they confine themselves exclusively to tax issues. They were and are concerned as well with the level of government spending, government regulation, and monetary issues. However, they did achieve their greatest success in pointing out the evils of high progressive tax rates, which led to passage of legislation to reduce marginal income tax rates in 1981 and again in 1986.

Even so, the idea that marginal tax rates (the tax rate on the last dollar earned) might be so high that government revenue is depressed is by no means an original concept. Adam Smith, for example, wrote in *The Wealth of Nations:* "High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to government than what might be drawn from more moderate taxes."[1] The idea is also well grounded in Austrian economics. In *Human Action,* Ludwig von Mises wrote:

> Businessmen complain about the oppressiveness of heavy taxes. Statesmen are alarmed about the danger of "eating the seedcorn." Yet, the true crux of the taxation issue is to be seen in the paradox that the more taxes increase, the more they undermine the market economy and concomitantly the system of taxation itself. Thus the fact becomes manifest that ultimately the preservation of private property and confiscatory measures are incompatible. Every specific tax, as well as a nation's whole tax system, becomes self-defeating above a certain height of the rates.[2]

It is also worth mentioning that another Austrian, Henry Hazlitt, often argued against high marginal income tax rates on the grounds that a reduction in such rates would increase government revenue.[3] But as noted earlier, this narrow concept of raising revenue from lower tax rates is really only a sideline. The real essence of supply-side economics is its effort to reduce government intervention in the economy.

In order to reduce government intervention, however, supply-siders found it necessary to confront the prevailing Keynesian orthodoxy on such issues as taxation and the budget deficit. In the mid-1970s, when supply-side economics first appeared, the Keynesian model

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was firmly entrenched in economic policymaking. It was conventional wisdom among both Republicans and Democrats that the government could stabilize the economy through demand management; increasing the budget deficit through increased spending or lower taxes when the economy slowed down, and raising taxes and lowering the deficit when inflation arose.

In the Keynesian framework, only aggregates mattered and demand was the lever which moved the economy. Turning Say's Law on its head, policymakers behaved as though demand created supply. All they had to do was ensure that people had sufficient purchasing power and producers would automatically produce what was needed. But by the mid-seventies, when inflation began to reach dangerously high levels even with high unemployment, this thesis could no longer be sustained.

Reaffirming Say's Law

Thus a central aim of the supply-side movement was simply to restore the idea that the supply side of the economy mattered; that policymakers could not continue to blithely ignore incentives, profit margins, rates of return, and other factors of production. In fact, one aim was nothing less than the re-establishment of the truth of Say's Law. Indeed, one might argue that Jean Baptiste Say was the first supply-sider. As he wrote in his *Treatise on Political Economy,* "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. . . . Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption."[4]

Say's Law, of course, is central not only to supply-side economics, but Austrian economics as well.[5] And as the Keynesians themselves have pointed out, if one accepts the validity of Say's Law—which simply states that commodities are ultimately paid for with other commodities—then the whole Keynesian system collapses. As Keynesian Paul Sweezy put it: "The Keynesian attacks . . . all fall to the ground if the validity of Say's Law is assumed."[6]

In classical political economy there was no distinction between what is called macroeconomics—the economics of the economy as a whole—and microeconomics—the theory of prices and the firm. The distinction was created by John Maynard Keynes, who argued that there are laws of economics which operate differently in the macroeconomy than they do in the microeconomy. For example, price theory indicates that when there is an oversupply of goods, prices must fall to meet demand. Hence, there can never be a general oversupply of goods so long as prices are free to adjust.

Keynes, however, argued that while this may be true for particular goods, it is not true for the economy as a whole. In the case of labor, in particular, he said that wage cuts would not be a satisfactory solution to the problem of unemployment, because as wages decline workers would lose income, thereby reducing their ability to purchase goods and services, leading to a further decline in economic activity. Thus the solution to the problem of oversupply lies in increasing demand, rather than lower prices. This led him to propose budget deficits as the key to stimulating growth.

In Keynes's defense, he never intended for deficits to go on indefinitely, nor was he an advocate of inflation, except under the deflationary conditions of the Great Depression. Even Hayek believes that had Keynes lived longer—he died in 1946—that he would have been a determined fighter against the inflationary policies pursued by governments in the name of Keynesian economics.[7]

By the mid-1970s the failure of Keynesian economics was too obvious to be ignored any longer. Inflation was escalating at ever faster rates and the Keynesians had no satisfactory explanation of the problem or a cure for it, because money plays little role in Keynesian theory. At the same time, budget deficits seemed to lose their stimulative power. As deficits increased, so did unemployment. Thus the Keynesians were left with no policies to offer against the twin problems of rising inflation and rising unemployment. Indeed, in the Keynesian system one should always be able to trade inflation for unemployment, as the so-called Phillips Curve indicates. You weren't supposed to have both at the same time.

In this environment, the supply-siders attempted to resurrect the forgotten truths of classical economics—elevating, in a sense, microeconomics to the macro economy. To the problem of inflation, they argued for tight money and a return to the gold standard. To the problems of unemployment and slow growth they insisted that high marginal tax rates had to be reduced and government regulations dismantled.

The Effects of Taxes on Employment

Supply-siders believed that inflation had sharply raised tax rates, as people were pushed into higher tax brackets. High tax rates, in turn, altered key relative prices: the price between saving and consumption and the price of work versus leisure. As tax rates rise one will get less saving, more consumption, less work, and more unemployment. Moreover, supply-siders argued, taxes imposed a "wedge" between effort and reward, which explained the rise of unemployment. If a worker finds that higher wages only push him into a higher tax bracket, then he is forced to ask for even higher wages in order to achieve a real, after-tax increase in pay. Hence, higher taxes raise the cost of labor and, consequently, employers demand less of it.

Thus taxes may produce the same kind of malinvestment usually associated with inflation. Investment naturally moves out of heavily taxed sectors into less heavily taxed sectors; if necessary, into the so-called underground economy. During the 1970s one of the hottest businesses was tax shelters, in which paper losses are generated by uneconomic enterprises solely for the purpose of reducing taxes. We found an increasing portion of the nation's capital going into such tax-favored sectors as housing, starving the nation's industrial sector of capital and explaining much of the decline in America's industrial competitiveness.

These negative tax effects are exacerbated by inflation. Inflation increases nominal (money) incomes, pushing people into higher tax brackets when tax schedules are steeply graduated. Consider a family with an income of $19,380 in 1965. This family paid 15.6 per cent of its income in Federal income taxes and a 25 per cent tax rate on each additional dollar earned. By 1980, had this family's income kept pace with inflation, its income would have risen to $45,000 per year. Obviously, its real income has not risen at all, in terms of the goods or services it could purchase with that income. However, because the tax system did not take inflation into account, this family faced a steep increase in taxation. By 1980 it was paying 22.6 per cent of its income to the federal government and paid a 43 per cent tax on each additional dollar earned—its marginal tax rate.[8]

Supply-siders emphasize the economic effects of the marginal tax rate because they believe this is the key tax rate affecting economic decision making. If an individual has a choice between saving or spending his income, the choice will be largely determined by the after-tax rate of return on saving and that return will be determined by the marginal tax rate.

Consider an individual with $100,000. Until 1981 this person could have paid a Federal income tax rate as high as 70 per cent. If the rate of interest is 10 per cent, then his after-tax return might be only $3,000 per year on an investment of $100,000. Thus the cost to him of spending that $100,000 on consumption or the purchase of some good, such as a fine painting, which gives him untaxed income in the form of psychic pleasure, is only $3,000 per year. In this way, high marginal tax rates discourage productive investment and encourage consumption. Since increasing capital formation is the principal means by which the standard of living is raised, the effect of high marginal tax rates is to reduce well-being.

Mises clearly understood this and also emphasized another key point made by supply-siders: The greatest impact of high marginal tax rates is on the entrepreneur. The discouragement of entrepreneurship, in turn, deprives society of its dynamism and will lead to stagnation.[9]

It is worth remembering that the greatest impetus to entrepreneurship in many years took place in 1978 when, under the leadership of supply-siders, Congress cut the maximum tax rate on capital gains in half. Supply-siders argued that the capital gains tax was especially harmful to entrepreneurs because their profits —if there are any—usually come in the form of large capital gains rather than income. It is now widely recognized that the 1978 and 1981 cuts in the capital gains tax unleashed an avalanche of entrepreneurship, innovation, risk-taking, and inventiveness which have already benefited our country in countless ways in the form of new products, processes, and businesses which simply would not have resulted without this critical tax change.[10]

Interestingly, the data from both the capital gains tax cut and the reduction in the top personal income tax rate indicate that revenues did in fact rise.[11] They did not rise sufficiently, however, to prevent a large increase in the budget deficit. This is one area where Austrians have been particularly critical of supply-siders.

The problem is that many people forget that if government revenues increase, then spending can also rise without increasing the deficit. During the 1970s, government spending ballooned without a proportionate rise in the deficit because inflation was leading to a sharp rise in taxes, as people were pushed into higher tax brackets. As much as one might be concerned about the financial effects of deficits, no believer in a free society and a free economy can support tax increases solely to reduce deficits. It would be self-defeating because governments will always spend all the money they can get and because the negative economic effects of higher taxes would be greater than whatever negative effects arise from deficits.

This is why some economists, like Milton Friedman, always advocate tax cuts even without corresponding spending cuts, though a deficit would be the result. "I would far rather have total federal spending at $200 billion with a deficit of $100 billion," he says, "than a balanced budget at $500 billion."[12] The key, of course, is to lower government spending and taxation whenever and wherever possible, because they are the true burden of government, regardless of what the deficit is.

The main problem supply-siders have always had with those who voice concern about deficits is that they lend support to those whose true goal is to raise taxes, not cut spending. The correct goal is and should be to reduce government's share of the private economy any way possible. On this, supply-siders and Austrians have no disagreement.

In conclusion, one might usefully think of supply-side economics as a way of rephrasing and repackaging the great truths of Austrian economics in a way to make them more easily understood and appreciated by policymakers. It should be remembered that the great Austrian economist Böhm-Bawerk served as Minister of Finance of Austria and that even Mises spent much of his life as a quasi-government economist for the Lower Austrian Chamber of Commerce, Handicrafts and Industry.[13] They understood well the barriers to adoption of sound economic policies by governments and the value of recasting one's argument to appeal to current concerns and interests. This is not compromise, merely the exercise of political skill.

Ultimately, it must be recognized that the supporters of a free society are few and weak. Their ranks should not be further weakened by misunderstood differences in approaches to political questions when there is no fundamental disagreement on ends. □

1. Adam Smith, *The Wealth of Nations* (New York: Random House, 1937), p. 835.
2. Ludwig von Mises, *Human Action* (New Haven: Yale University Press, 1949), p. 734.
3. Henry Hazlitt, "High Taxes vs. Incentive and Revenue," *Newsweek* (April 7, 1947), p. 70; *idem*, "High Taxes vs. Revenues," *Newsweek* (April 26, 1954), p. 82.
4. Jean Baptiste Say, *A Treatise on Political Economy* (Philadelphia: Grigg & Elliot, 1834), p. 143.
5. See Ludwig von Mises, "Lord Keynes and Say's Law," *The Freeman* (October 30, 1950), reprinted in *Planning for Freedom*, 4th ed. (South Holland, Illinois: Libertarian Press, 1980), pp. 64-71. See also Henry Hazlitt, *The Failure of the "New Economics"* (Princeton, N.J.: D. Van Nostrand, 1959), pp. 32-43.
6. Paul Sweezy, "Keynes the Economist," in Seymour E. Harris, ed., *The New Economics* (New York: Alfred A. Knopf, 1950), p. 105. For background on Say's Law, see W. H. Hutt, *A Rehabilitation of Say's Law* (Athens, Ohio: Ohio University Press, 1974), and Thomas Sowell, *Say's Law* (Princeton, N.J.: Princeton University Press, 1972).
7. F. A. Hayek, "Personal Recollections of Keynes and the 'Keynesian Revolution,'" *Oriental Economist* (January 1966), reprinted in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), pp. 286-7.
8. Internal Revenue Service, *Statistics of Income Bulletin* 2(Winter 1982-83), p. 18.
9. Mises, *Human Action*, pp. 804-5.
10. The most comprehensive review of the effects of the capital gains tax cut is found in Department of the Treasury, Office of Tax Analysis, *Report to Congress on the Capital Gains Tax Reductions of 1978* (Washington: U.S. Government Printing Office, 1985).
11. Lawrence B. Lindsey, *Taxpayer Behavior and the Distribution of the 1982 Tax Cut* (Cambridge, Mass.: National Bureau of Economic Research, Working Paper No. 1760, October 1985).
12. Milton Friedman, "The Limitations of Tax Limitation," *Policy Review* (Summer 1978), p. 12.
13. See Ludwig von Mises, *Notes and Recollections* (South Holland, Illinois: Libertarian Press,1978), pp. 71-92.

Power and Peasantry: A Report from the Soviet Union

by Sven Rydenfelt

During the first few years after the 1917 Bolshevik Revolution, Russian manufacturing production fell to a fraction of its pre-World War I level. Even worse was the steep decline in food deliveries to the cities. The Lenin government tried to support the townspeople by sending armed patrols to search the farms, confiscating everything edible they could find, including livestock, seed grain, and the peasant families' own food.

By gradually slaughtering and eating the stock of domestic animals and by increasing the proportion of grain and vegetables in the diet, the basic needs of the population were met during the first three years. But in 1921 the oppression and exploitation of the peasants ripened into famine.

The Lenin regime blamed the famine on poor harvests in the Ukraine and other Russian granaries caused by droughts and bad weather. Here Lenin established a precedent for his successors who have consistently blamed crop failures on natural disasters. The Lenin myth was generally believed, and the 1921 famine was interpreted as an unavoidable catastrophe.

Relief expeditions on a massive scale were sent from countries in the West, including the United States. The most important was organized by the League of Nations under the leadership of the Norwegian polar explorer Fridtjof Nansen (awarded the Nobel Peace Prize for this and other achievements in 1922). The lives of 12 to 13 million people were saved, but several millions, most of them peasants, perished. Not only did the relief efforts save tens of millions of lives, but in all probability the Communist regime was saved as well. Without massive relief the famine would have reached such proportions that no regime would have been able to survive.

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Stalin's Legacy

In 1929, Stalin felt sufficiently secure to start a massive offensive to socialize the peasants and their private production apparatus. The attack on the private farms, which had increased in number to 25 million as a result of the confiscation and division of the large estates, was not solely ideologically motivated. There was also an economy of scale motive: 25 million "ineffective" small family farms were to be replaced by larger, more effective state farms and collectives.

In addition, there was an administrative motive: it would be easier to manage and control a limited number of big enterprises than millions of small enterprises.

The collectivization of Russian agriculture was carried out with ruthless brutality and terrorism. A catastrophic crop reduction quickly followed. According to the best available estimates—official reports were never published—between 1929 and 1933 five million people died of starvation and five million more were liquidated by the Communists. Special targets for the terror were the owners of large farms—kulaks—accused of being leaders of the