SUPPLY-SIDE ECONOMICS

Supply-side economics, like any economic theory, means different things to different people. I’ll try to summarize the main points common to most supply-side theorists.

Supply-side economics emphasizes the incentives created by taxes (which discourage activities) and subsidies (which encourage activities). It focuses on long-run economic growth, rather than on short-run stabilization. It has much in common with classical economic theory, adapted to modern times.

There are three main policies advocated:
1) Reduce tax RATES, not for the income effect on spending but for the incentive effects in encouraging work, saving, investment, and production.
2) Restrictive monetary policy to complement the policy of lower tax rates, limiting any demand-pull inflation that might be caused by lower tax rates, higher disposable income, and greater aggregate spending.
3) Reduce any federal budget deficit by cutting government expenditures. This will lead to less government intervention and regulation. It also reduces the government’s need to borrow (which forces interest rates up and discourages private investment) or print money (which causes inflation and higher nominal interest rates).
4) (Secondary) Policies to make markets more competitive (enforcing anti-trust, extending anti-trust to labor unions, and reducing or eliminating price controls like the minimum wage).

Important to the supply-side theory is the idea that tax rates and tax revenues are not always directly related. Tax revenue equals the tax rate times the tax base. As taxes are increased, they create bigger and bigger disincentives to work (reducing the tax base). Eventually, when tax rates are high enough, raising tax rates will decrease tax revenue. In that case, lowering tax RATES would increase tax REVENUES.

Criticisms:
Cutting tax rates may be inflationary in the way that Keynesian theory suggests (increasing disposable income and aggregate demand). Supply-siders say controlled and restrictive monetary growth will prevent demand-pull inflation.

There is no guarantee that consumers, workers and firms will change their behavior in response to lower tax rates. People might not work harder or longer, firms might not produce and invest more, households might not save more and spend less.

Some economists believe that tax incentives are unlikely to provide sustained increases in the rate of growth of real output. They say that if there is any effect at all it is likely to bring about small, one-shot increases in real output. Historically it has been very difficult to increase the growth rate of real output. Even in the most favorable circumstances, supply-side increases in output are unlikely to have much of an effect on inflation.

We don’t know what tax rate would maximize real output or tax revenues, and the current tax rates could be below that hypothetical tax rate. If so, a reduction in tax rates could reduce output, reduce tax revenues, and increase the federal budget deficit.

Finally, there is much debate about the time lag between the cut in tax rates and the increase in aggregate supply that might result. The adjustment period could be long, and could involve both high unemployment and high inflation.