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# Reaganomics and the Supply-Side: A Rationale

J. Kenneth Davies

This paper is not intended as a defense of the Reagan economic program as such, nor even of the Reagan political posturing and rhetoric. These are in a constant state of flux made necessary by changing political and economic forces as well as the bargaining game being played between the president, Congress, public-pressure groups, and factions within the administration itself.

It is intended to present some economic facts and to identify a set of economic principles which just might help extricate the nation from the multifaceted economic dilemma it now faces.<sup>1</sup> This set of principles is often referred to in the popular literature as Reaganomics, but this term is far too narrow and is frequently used by liberals pejoratively, indicating the concepts originated with President Reagan. Also referred to as supply-side economics, these principles are historically valid enough to stand on their own. While they have, by and large, been espoused by President Reagan and a number of his advisors, they are by no means the product of or limited to that group. They are principles being given consideration by a small but growing number of economists searching for a viable alternative to the liberal Keynesian policies which have been in force worldwide and which in the opinion of some have helped lead the U.S. and much of the world into the present economic problems. And it is obvious that such policies have been unable to respond effectively. The principles of Reaganomics or supply-side economics are philosophically related to but not synonymous with classical economics.

To understand and evaluate this set of principles, the reader must first recognize the economic milieu facing America as 1980 passed into 1981. Most of these points represent long-run trends:

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<sup>1</sup>The essence of this article was developed in the late spring of 1982. By the late fall, the economic data indicated substantial improvement; however, the long-run problems still remain. We may have turned the corner, but the road ahead is still long.

1. Industrial production was falling, having decreased from an index of 152 in 1979 to 147 in 1980.
2. Unemployment had risen from 5.8% in 1979 to 7.1% in 1980, an increase of 22%.
3. Prime interest rates had almost doubled during the previous year, having reached a peak of 21.5%.
4. The rate of inflation had risen from a consumer price index of 5% in 1976 to a peak of 13.3% in 1979.
5. Productivity (output per hour) was down, having fallen about one percentage point since reaching a high in 1977 as compared with a 7% increase between 1974 and 1977.
6. Corporate profits had fallen from an index of 197 to 182 in one year.
7. The national debt was continuing its skyrocketing growth, increasing by \$83 billion in 1980—and that during a period of international peace.
8. The Social Security system was almost bankrupt.
9. Bankruptcies were proceeding at a forty-year high.
10. The economy was so enervated that the value of the American dollar in the international trade had been falling for years.

There was not one major positive aggregate economic statistic in 1980–81. There was no better formula for economic disaster.

#### A HISTORICAL PERSPECTIVE

It must be remembered that this condition had been generating over a period of many years in which Keynesian economics and social liberalism had dominated economic thought and American public policy. In all fairness, the importance of what was happening was really unknown to most economic observers and policy makers until the 1970s. Most economists had been swept into the Keynesian tide, and it was not until that decade that they first became aware of the coexistence of both excessive inflation and high unemployment, which has come to be called stagflation.

During the 1930s there was excessive unemployment but no inflation; in the 1940s the nation experienced war-induced inflation but little unemployment. While there were several recessions during the Eisenhower years, prices and interest rates were relatively stable.

The tragically abbreviated Kennedy years were also reasonably comfortable, the economy making progress against unemployment with relatively stable prices. It is perhaps understandable that both academic economists and policy makers perceived inflation and recession as mutually exclusive—that there could be one or the other but not both together. Public policy could then be devised which simply either reduced unemployment or inflation. This was public policy compatible with Keynesian-oriented economic analysis. The politics of Keynesian-oriented policy was, however, another story. Policy directed toward recession was politically popular; that against inflation was unpopular.

It was during the Johnson war years (1963–68) that a major economic blunder was made which set in motion forces which brought stagflation. It was assumed that the nation could have both “guns and butter.” After all, we were the richest, most powerful nation in the world, and it was generally thought that we could continue to support both a war and a high level of consumption. The nation engaged in an expensive and protracted war in Southeast Asia without making the necessary domestic consumer sacrifices. Little attempt was made to restrain prices and wages. In addition, the newly launched War on Poverty was continued through a period of escalating prices. The result was inflation, worsened by the “supply shocks” of worldwide shortages of food, fiber, and oil as the nation moved into the seventies. The inflation became so entrenched that the public came to expect that inflation would continue, and people developed all sorts of devices to protect themselves against its effects. These devices in turn acted to insure wage–price escalation with inflation feeding upon itself. A people expecting inflation and acting accordingly produces what has been referred to as inflationary expectations. Keynesian demand management was politically unable to correct that problem. The required increased taxes and/or reduced government spending were both political anathema.

The 1970s became a decade characterized by both rapidly rising prices and rapidly increasing unemployment. The public-policy dilemma was that when action was taken to restrain inflation, unemployment increased; when steps were taken to reduce unemployment, inflation resulted. The only way out of this dilemma seemed to be the imposition of price and wage controls while the government and the Federal Reserve stimulated the aggregate demand in hopes of reducing unemployment through fiscal (decreased taxes and increased spending) and monetary (increased money supply) policy. The American people were not prepared to accept for long such a

radical solution. The controls, reluctantly imposed by Nixon, ended without ceremony but with to-be-expected rapid escalation of prices.

By 1980 it became apparent that the practices of Keynesian economics and social liberalism were unable to contain or control the aggregate economy. While many of the goals were laudable—prosperity, stability, and justice—after fifty years of operation, leaders had not been able to achieve them in concert. It became increasingly apparent to many that full employment, stable prices, a high rate of economic growth and economic freedom were mutually incompatible although they were desirable. The attempt to engineer them had failed, producing the economic instability of the 1970s.

### THREE AGGREGATE ECONOMIC MODELS

This failure resulted in large measure from some false economic assumptions and the resultant invalid conclusions. These errors can be illustrated by contrasting three highly simplified models representing pre-Keynesian, Keynesian, and post-Keynesian aggregate economics.<sup>2</sup>

#### *The Pre-Keynesian Model*

The classical model dominating economic thought until the 1930s assumed a long-run aggregate supply (AS) curve or function in

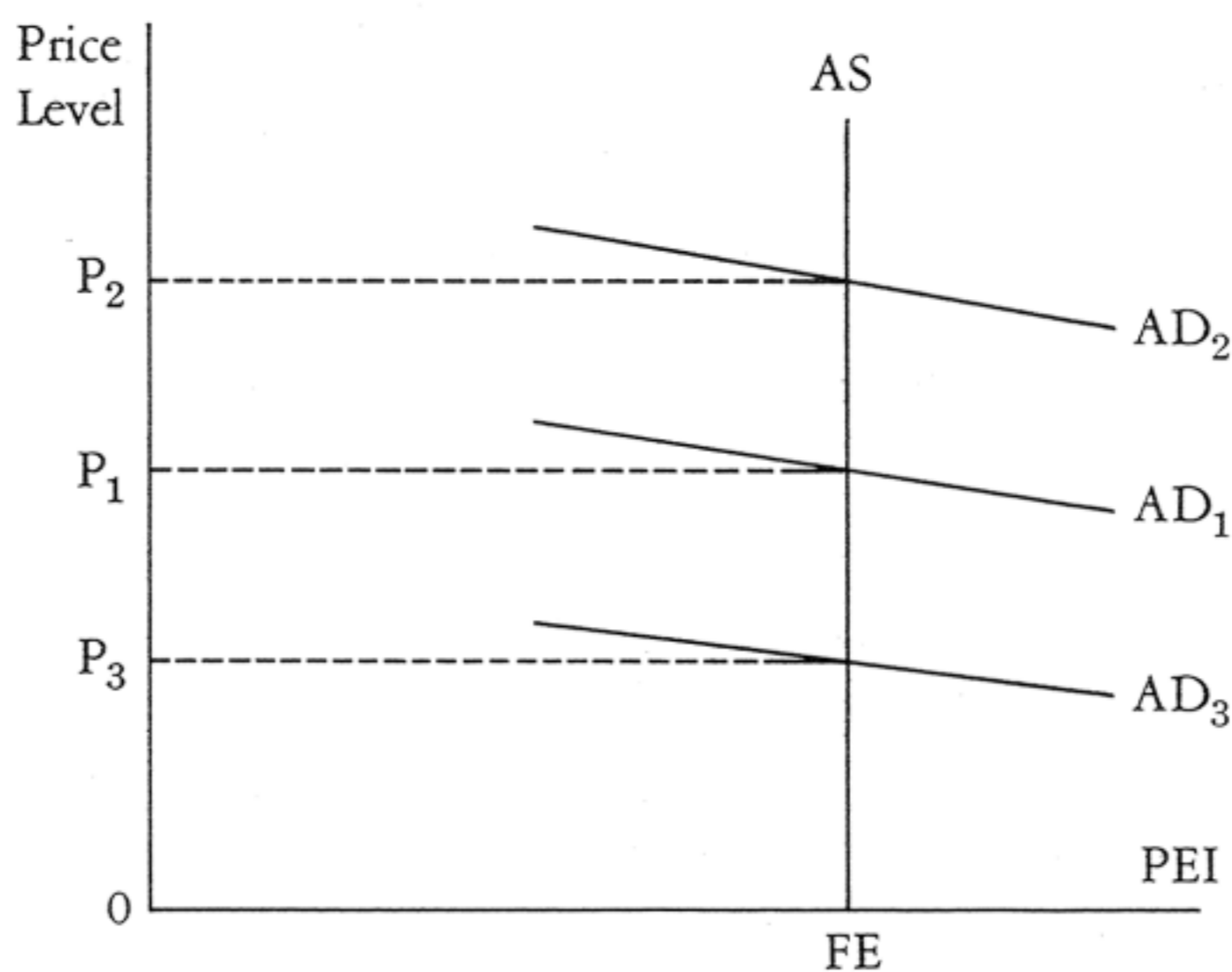


Figure 1. Pre-Keynesian, Classical Model

<sup>2</sup>The author recognizes the limitations of these simplified models but views their expository advantages as outweighing their limitations.

which production, employment, and income (PEI) would be at the full-employment (FE) level, maintained there by perfectly flexible prices and wages. This is illustrated in figure 1. If the economy produced too little relative to demand, prices and wages would automatically increase, stimulating production; if too much were produced, prices would quickly fall, reducing production. The induced aggregate demand (AD),<sup>3</sup> regardless of its level, would be sufficient to maintain full employment whether at  $AD_1$ ,  $AD_2$ , or  $AD_3$ . Unemployment would not exist for long. There was no need for government intervention. Economic ills would cure themselves.

### *The Keynesian Model*

In the 1930s, John Maynard Keynes and liberal philosophers recognized the errors of assumptions and conclusions in classical economics. While prices and wages could increase, they were not flexible downward; aggregate demand did not always respond quickly to changes in aggregate supply; high unemployment could exist for excessively long periods of time; it appeared that economic ills would not necessarily cure themselves. The decade-long depression of the 1930s seemed to be proof of this. Their new model is illustrated in figure 2. They assumed an aggregate supply in which any level of

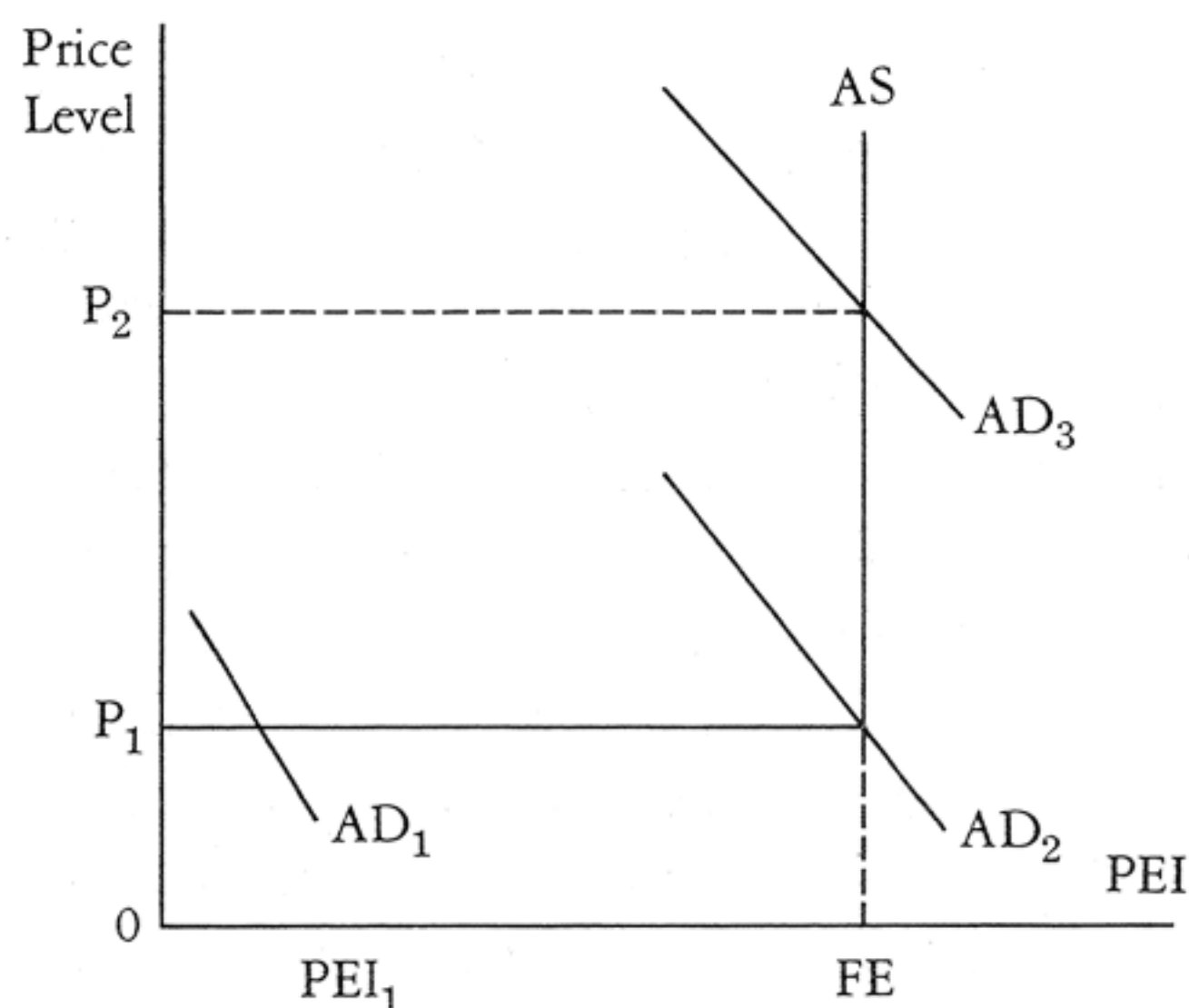


Figure 2. Keynesian Model

<sup>3</sup>Say's Law was assumed, namely that supply would create its own demand. Whatever was produced would automatically give rise to the demand for that production. According to Say, surpluses leading to recession were, in the long run, impossible. (See William J. Baumol and Alan S. Blinder, *Economics* [New York: Harcourt, Brace, Jovanovich, 1982], p. 778).

production would be achieved up to the full-employment level (FE) by stimulating aggregate demand ( $AD_1$  to  $AD_2$ ) without any inflation. Any stimulation of AD beyond that point (to  $AD_3$ ) would be inflationary, prices rising to  $P_2$ . They also assumed that aggregate demand on its own was usually insufficient to achieve full employment, that, operating on its own devices, it would be to the left of the full-employment level. Implicit in their model was the assumption that demand creates its own supply. Create the demand necessary to achieve full employment and the needed supply would be forthcoming. This is just the opposite of the classical model.

Government was the only effective means of stimulating aggregate demand to the full-employment level. It could be reached through fiscal and/or monetary policy which would compensate for any deficiencies of the private sector. The fiscal policy usually chosen was to increase government spending, meeting the modern-day liberals' agenda for increased government as the cure to socio-economic injustice. Reduced taxes could accomplish the same thing in aggregate terms, by leaving more money for the private sector to spend, but this would mean decreased government, an approach which is contrary to the liberals' prescription for socio-economic planning. To them, appropriate monetary policy was to increase the money supply, thus inducing low interest rates, which would in turn encourage spending. Implementing these policies would increase aggregate demand, thereby stimulating production and employment. Theoretically, full employment would be achieved without any inflationary effect. In the assumed "unlikely" event of inflation, the appropriate policy would be the reverse: decrease aggregate demand back to the full-employment level by reduced government spending, increased taxes, and/or decreased money supply.

The assumptions of the Keynesian model were no more realistic than were the pre-Keynesian ones, though they appeared to be so until the administration of President Johnson neared its close. As long as the economy experienced either recession or inflation, but not both at the same time, the Keynesian solutions seemed economically viable. But the Keynesian conclusions have not proven to be any more valid for the 1970s and 1980s than the pre-Keynesian ones for the 1930s because neither represented reality. A new model was clearly needed.

### *The Post-Keynesian Model*

It became apparent in the 1970s that there was a short-run inverse relationship between prices and unemployment, illustrated by

the Phillips curve (figure 3). At alternatively lower prices ( $P_1$ ,  $P_2$ ,  $P_3$ ), higher levels of unemployment ( $U_1$ ,  $U_2$ ,  $U_3$ ) would be experienced. At alternatively lower levels of unemployment, higher levels of inflation would exist. The public-policy implications of the Phillips curve are that because of the short-run trade-off between inflation and unemployment, the use of monetary or fiscal policy to correct either one only exacerbates the other. As action is taken to reduce inflation, unemployment increases; as action is taken to reduce unemployment, inflation increases.

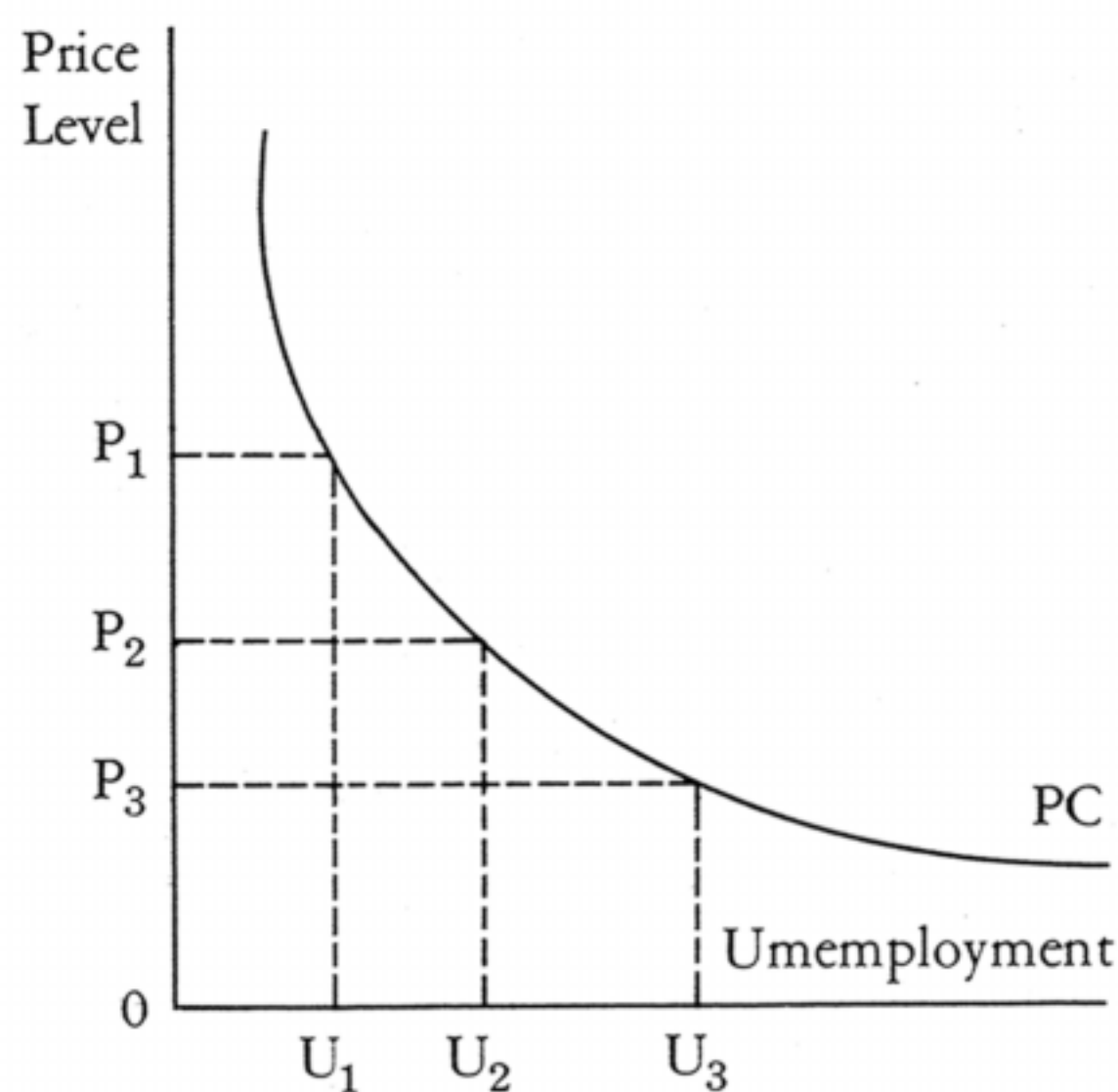


Figure 3. Phillips Curve—Short-run Movement

Further complicating the issue was the apparent long-run movement of the Phillips curves up and to the right during the 1970s—worsening the trade-off. At any given price level ( $P_1$ ), unemployment was worse ( $U_1$ ,  $U_2$ ,  $U_3$ ); at any given level of unemployment ( $U_a$ ), prices were higher ( $P_a$ ,  $P_b$ ,  $P_c$ ), as illustrated in figure 4.

The mirror image of the Phillips curve relates prices to production, employment, and income (PEI), illustrated by an aggregate supply curve which rises to the right as in figure 5. It may be seen that with a given aggregate supply, the higher the level of PEI ( $E_1$ ,  $E_2$ ,  $E_3$ ), the higher the prices ( $P_1$ ,  $P_2$ ,  $P_3$ ), and all this at an escalating rate.<sup>4</sup>

<sup>4</sup>The author recognizes that there may be challenges as to the slope of the aggregate supply curve. He has chosen to include in a given curve the extremes of the Keynesian range (the relatively flat portion) and of the classical range (the relatively verticle). There are those who would eliminate either or both of the extremes.



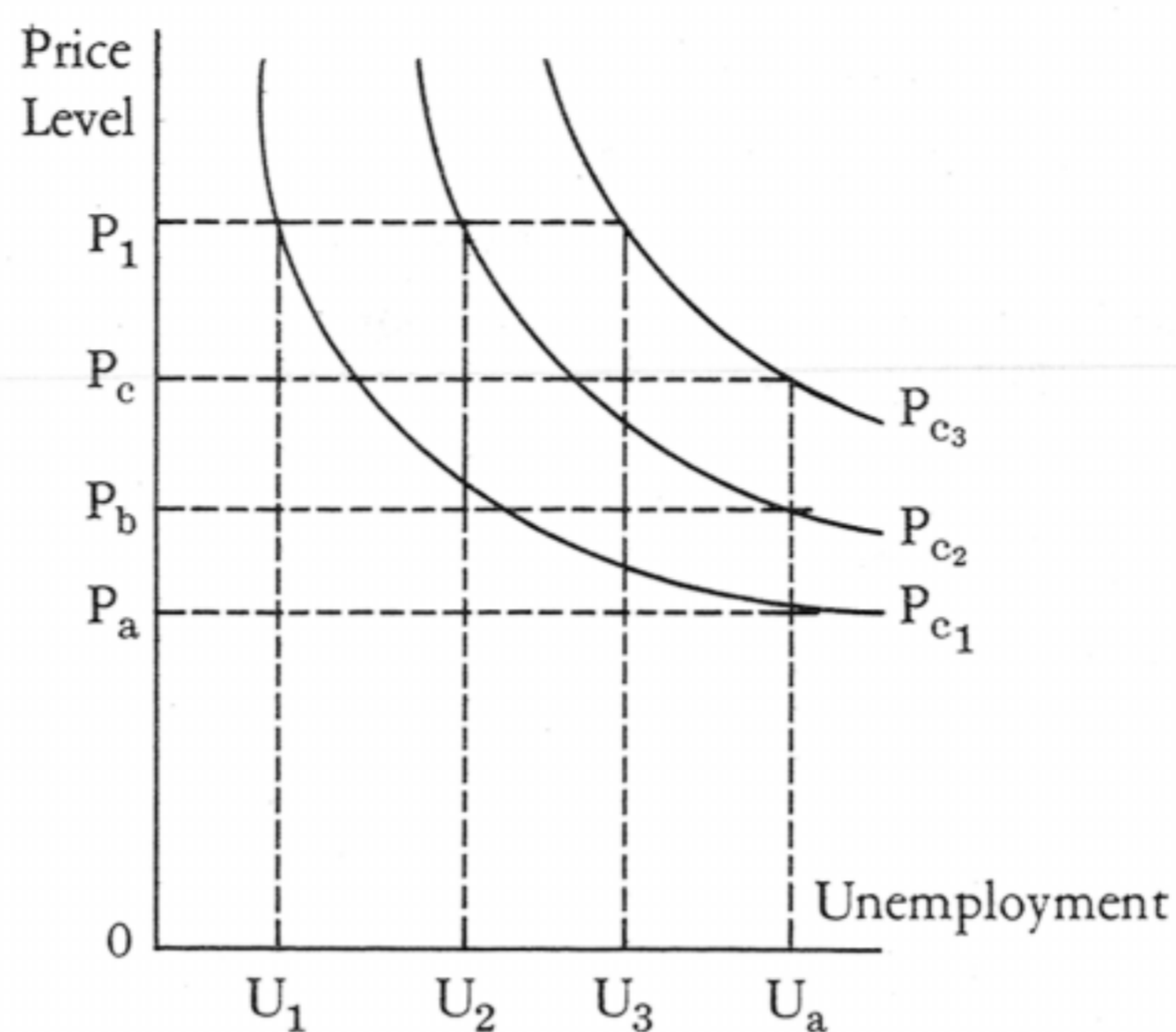


Figure 4. Phillips Curve—Long-run Movement

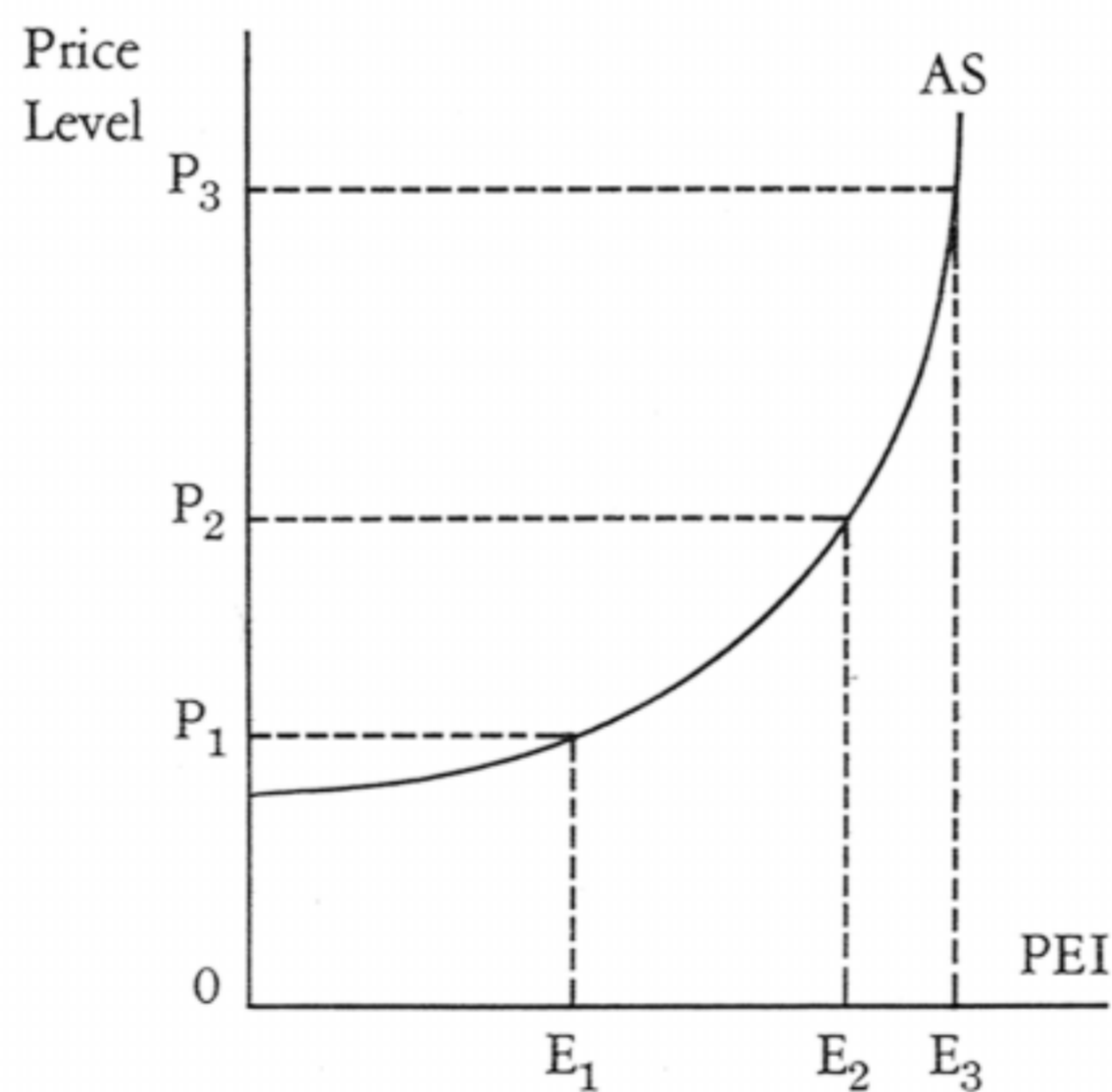


Figure 5. Aggregate Supply—Post-Keynesian Model

If the economy is at a very low level of PEI, aggregate demand could be stimulated, say from  $AD_1$  to  $AD_2$  (shown in figure 6), with substantial effect on production, employment, and income ( $E_1$  to  $E_2$ ) but with little effect on prices ( $P_1$  to  $P_2$ ). But at higher levels of

production, increases in production could be achieved only at the expense of larger and larger increases in prices,  $P_3$  to  $P_4$ .

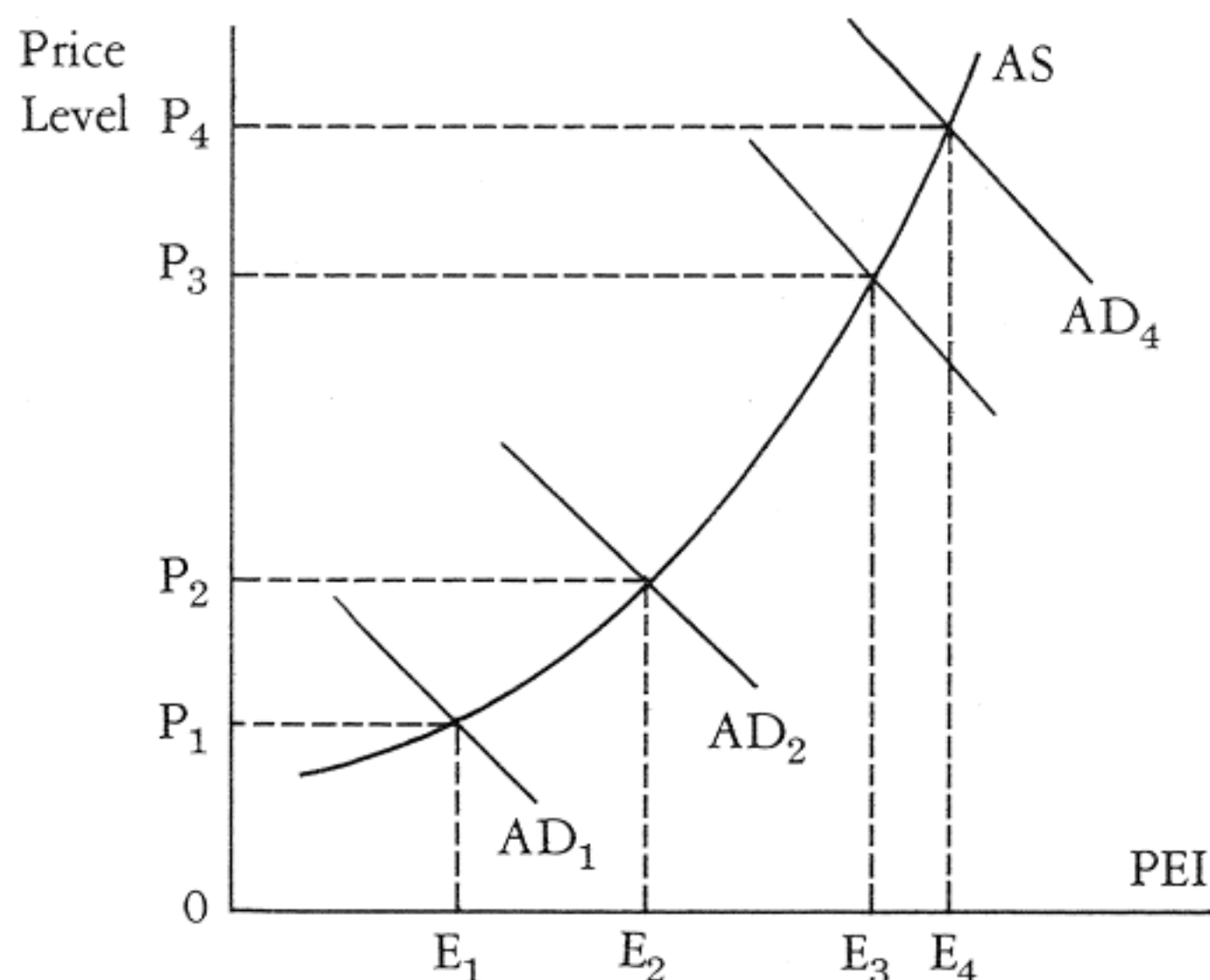


Figure 6. Increasing Aggregate Demand

However, should aggregate supply be diminished from  $AS_1$  to  $AS_2$ , as seen in figure 7, prices would continue to rise ( $P_1$  to  $P_2$ ) while PEI would be diminished ( $E_1$  to  $E_2$ ) and consequently unemployment would be increased.

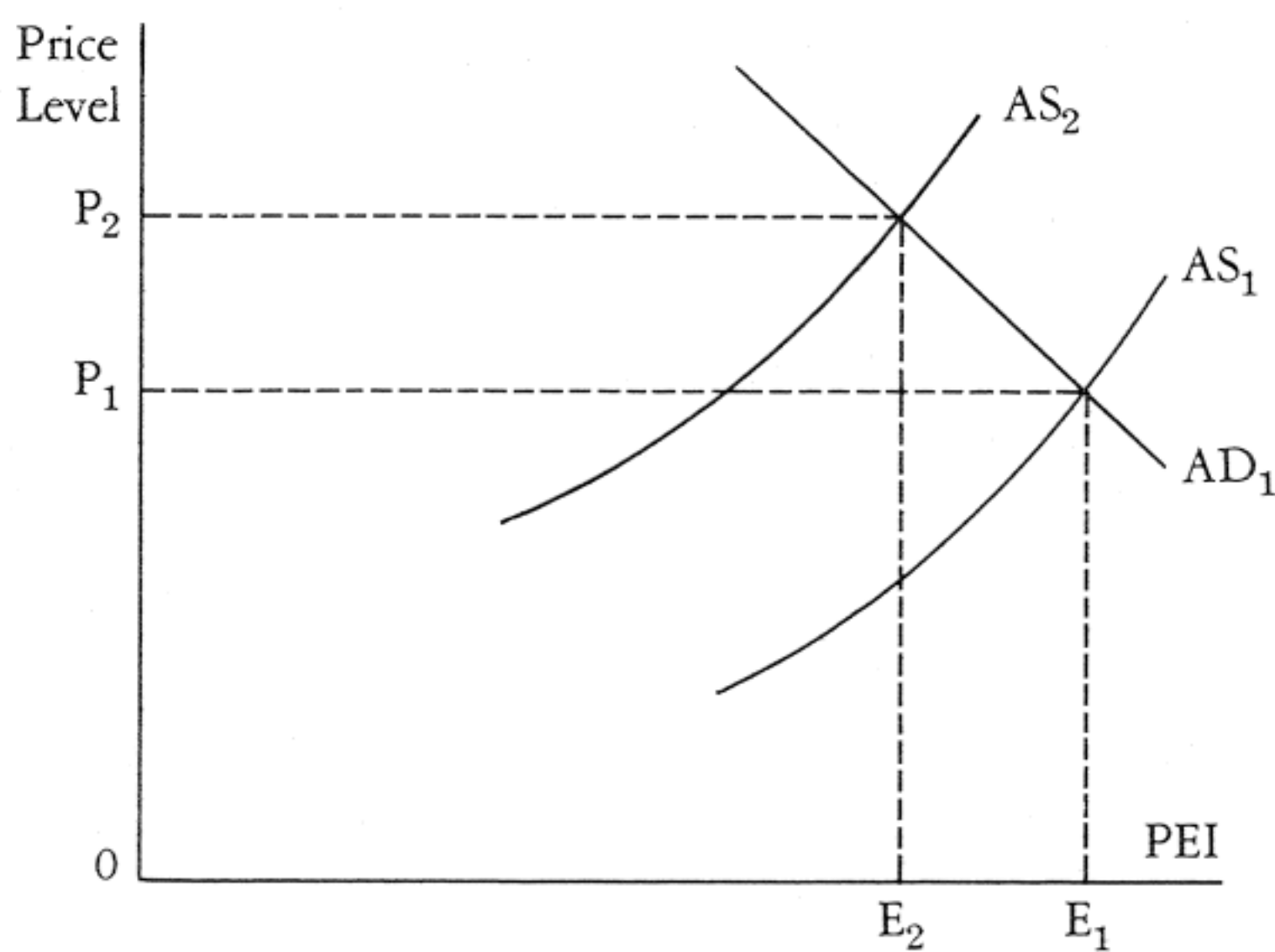


Figure 7. Decreased Aggregate Supply

On the other hand, should aggregate supply increase from  $AS_1$  to  $AS_3$ , as shown in figure 8, higher levels of PEI ( $E_1$  to  $E_3$ ), with reduced unemployment, could be achieved and at lower prices,  $P_1$  to  $P_3$ .

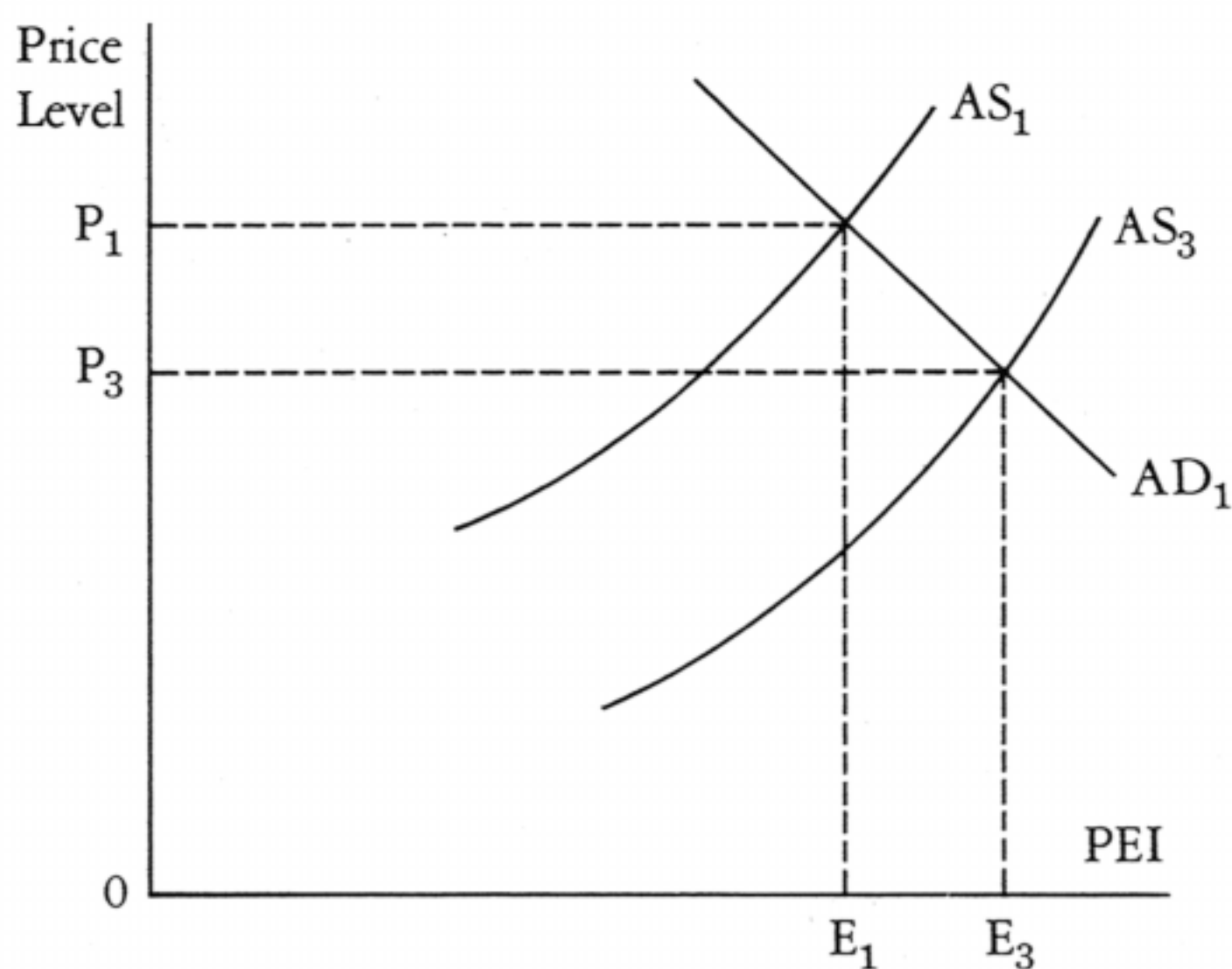


Figure 8. Increased Aggregate Supply

#### LIBERAL SOCIAL PROGRAMS

Keynesian economics relied almost solely on the stimulation of aggregate demand to achieve high levels of production, employment, and income, and, consequently, lower levels of unemployment—its primary concern. There was little concern for aggregate supply or inflation. Beginning in the 1930s, the liberal establishment began to put into place a number of programs with the most desirable and democratic of individual and immediate goals and objectives. They would correct and eliminate the socio-political-economic injustices of the existing American system. They would create a new freedom—freedom from fear. The poor would be lifted up, the rich would be brought down, through subsidies to the former and graduated income taxes on the latter. The nation's ills would be solved primarily through the intervention of the federal government. Keynesian economists probably little realized the aggregate effect of these programs. America was rich and powerful and knowledgeable enough to conquer any foe, including poverty.

Illustrative of these programs is a far-from-complete list of government programs, each designed to correct a given ill:

1. To correct the poverty often associated with industrial accidents and disease, we created OSHA (Occupational Safety and Health Administration).
2. To reduce the personal cost of unemployment, we established unemployment compensation.
3. Because of the economic distress associated with old age, we instigated the Social Security system.
4. To create a floor under the standard of living, we passed minimum wages.
5. To provide for social programs as well as pay for war, we developed highly progressive income taxes.
6. In our war against poverty, we developed a welfare program with the basic philosophy that the poor are entitled to relief payments untied to production. We even punished jurisdictions attempting to link them.
7. To clean up our environment, we created the Environmental Protection Agency.
8. To help the depressed farmers of the 1920s and 1930s through increased agricultural prices, we started a system of limiting the production of food and fiber.

Each of these programs in and of itself had a laudable end product in mind and alone would have placed no great strain on the economy. However, each one of them resulted in reduced production of goods and services and/or increased costs of production. The ultimate aggregate effect of all of these, and many other institutional changes beginning in the 1930s, has been to restrain the aggregate supply, driving up prices higher and higher with little if any positive effect on production and/or employment. In fact, the cumulative effect appears to have reached the point of actually reducing aggregate supply, moving it to the left, thereby driving up prices while actually reducing total production, employment, and income (PEI) and consequently increasing unemployment. This, associated with continued Keynesian efforts to achieve full employment through the stimulation of aggregate demand, along with continued supply shocks, has resulted in stagflation—higher and higher prices, stagnant or decreasing production with higher and higher levels of unemployment. Adding to the inflation has been the very expectation of continued inflation, with inflation feeding on itself.

## SUPPLY-SIDE AGENDA

Supply-side economics<sup>5</sup> is basically an attempt to stimulate aggregate supply faster than aggregate demand increases.<sup>6</sup> This could be done to a considerable extent by restraining aggregate demand while removing or reducing many of the artificial barriers to production created by much of the social legislation of the past forty years.

The position of many supply-siders is to change the mix of aggregate demand through the reduction of the government sector, thereby providing for the expansion of the private sector. The position of this author is that the basic supply-side goal (reducing the rate of inflation while stimulating production, employment, and income) can be accomplished without a significant reduction in the social welfare programs. It is probably this reduction and / or elimination of social welfare programs that raises the greatest resistance to supply-side economics.

There is a way out which would require little change in basic liberal goals and objectives. Economists, by and large (including contemporary Keynesians), know that in the long run and in the aggregate "there ain't no such thing as a free lunch." If people are going to eat, the food must first be produced. If those who are truly incapable of taking care of themselves are to be helped, every effort must be made to increase the aggregate production of goods and services. Little milk can be taken from a sick cow and there can be little care of the poor by a sick economy. The economy is going to be no healthier than its private sector, America's cow. If we want a lot of good milk, we must have a healthy cow; if we want goods and services enough for all, we must have a healthy, productive private economy.<sup>7</sup>

Following is a list of objectives, most of it in common with supply-side or Reagan economics, which just might help increase aggregate supply, reducing the trade-off between unemployment and inflation—that is, make possible lower rates of inflation concurrently with higher levels of production, employment, and income, and consequently lower unemployment rates:

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<sup>5</sup>Supply-side economics is often cluttered up with nonessential Laffer curves and a demand for a return to the gold standard. The validity of these is not essential to this analysis.

<sup>6</sup>The usual view of supply-siders is that if aggregate supply is permitted to grow aggregate demand will expand to absorb it. The view of this author is that public policy should not only consider the stimulation of aggregate supply but should also restrain the artificial growth of aggregate demand. This may be accomplished by restraining excessive increases in the rate of growth of the money supply.

<sup>7</sup>The Malthusian spectre is often raised as a challenge to supply-side economics. It is assumed by some doomsdayers that we have about reached the capacity of the world to increase aggregate supply. The spectre has been periodically proffered since the early 1800s.

1. *A limited and stable increase in the money supply.* In this country increasing the money supply is basically the function of the quasi-independent Federal Reserve system. The Federal Reserve must set a limited range within which it will allow the rate of growth of the money supply to fluctuate. This range must be in the neighborhood of the capacity of the economy to grow. If the money supply grows faster, it will induce inflation; if slower it will retard growth resulting in increased unemployment. Such action will play a major role in containing and stabilizing aggregate demand and consequently controlling inflation. It will make unnecessary the periodic, excessively harsh, reactionary, restrictive monetary policies which, along with huge federal deficits, have created the high interest rates of the past few years. These, in turn, have restricted private investment, resulting in recession.
2. *A reduction of taxes on savers and investors.* If taxes are reduced on savers and investors, the incentive to save and invest will increase, and consumption and aggregate demand will be restrained. The additional savings will reduce interest rates. The lower interest rates will encourage an increase of investment, making possible an increased aggregate supply, resulting in greater production, lower unemployment, and increased productivity, and making lower prices possible. In addition, the lower taxes will promote individual work effort.
3. *Removal of unnecessary, counterproductive regulatory controls, and subsidization of producers.* Removing counterproductive regulatory controls and subsidies will increase work incentives, increase output, and drive down costs of production, directly and through an increase in aggregate supply, with positive effects on both prices and unemployment.
4. *An increase of competition among producers and sellers.* There is some danger that competition may be stifled by the growth of domestic and international monopoly power as the private sector is encouraged to increase production. Such power tends to restrict production with negative effects on aggregate supply. If anything, competition should be increased, keeping

both prices and wages under control. The problem is identifying true monopoly power and developing viable programs to restrain it.

5. *An encouragement of the able bodied to leave welfare and enter the labor market.* Encouraging the able bodied to work may require actual discouragement to remaining on welfare. It will certainly require great ingenuity and a change in philosophy on the part of the welfare workers and administrators as well as of the law itself. It will also require a major manpower effort to assist those with little or no labor market skills to become productive and participating workers. The frequent liberal argument is that there is little sense developing market skills if there are no jobs, if all you give people is a hunting license to compete for non-existent jobs. This criticism becomes invalid if the rest of the program to remove the fetters on producers is effective in stimulating production and employment, thus restraining inflation. If there is criticism of the Reagan program, it is for the reduction in manpower programs directed toward this end.<sup>8</sup>
6. *Improvement of the efficiency of the operation of the labor market.* Improving the efficiency of labor will reduce the length of unemployment of workers and automatically increase production. This, too, is an area in which the Reagan program in its budget-cutting zeal seems to have erred by cutting too deeply into the budget of the Employment Service, which is one of the major aids in improving labor market efficiency.
7. *A decrease in government spending and the national debt as a percent of our gross national product.* If we can reduce government spending and the national debt, the public sector competition for loan funds will be reduced, driving interest rates down. The private sector will take up the slack, growing relative to the public sector. There would then be increased tax revenues even in the face of reduced tax rates on savers and investors. These increased revenues can then

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<sup>8</sup>However, in late September 1982, the Congress passed and the president signed the Job Training Partnership Act to replace the often criticized CETA (Comprehensive Employment Training Act) program.

provide the means of reducing the rate of growth of the federal deficit to less than the rate of growth of the economy.

This last objective will be difficult to achieve in the face of persistent international tensions requiring heavy defense-related spending. A guaranteed international peace could make the goal feasible. The question is how to achieve peace, and there is no easy answer to this conundrum. Foes of defense spending usually assume such spending to be a complete waste. However, it is not a complete loss. When the various weapons systems are built, people are at least put to work and receive income. The economic negative is that defense industry workers produce goods which do not enter the consumer marketplace, while their incomes do, stimulating consumer demand and prices. Economically this effect is much the same as a concentration of spending on nonproductive human services.

These seven objectives are, by and large, those of Reaganomic practitioners. Reaganomics may not be the perfect answer, but knowing that past Keynesian-oriented public policy makers' single-minded emphasis on aggregate demand has not achieved its goals, perhaps it is time we give supply-side economics the opportunity to prove itself. To do so will require time. Some progress has been made with both interest rates and inflation significantly lower than they have been for years. The inflationary expectations of the past decade already seem to be weakening under the pressure of the deep recession we have been experiencing. Labor unions have even been willing to negotiate contracts with substantial wage concessions and reduction of limitations on production. The index of industrial production appears to be inclining upward, and productivity (output per man-hour) is increasing. High-cost inventories built up in anticipation of continued inflation have been significantly reduced. The October upsurge of the stock market indicates renewed investor optimism. Making a significant reduction in the more intractable excessive unemployment rate will, unfortunately, take longer. But any renewed attempt to reduce unemployment simply through artificially stimulating aggregate demand by way of fiscal or monetary policy will probably set up a new wave of inflation, delaying a return to a stable, prosperous, and just socio-economic system.