Further reading

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ROHIT LEKHI

supply-side economics

'Supply-side economics' is school of economic thought emphasizing that the main source of a country's economic growth is constant improvement in the efficiency with which resources are allocated for production. While the policy recommendations of the rival Keynesian School (see KEYNESIAN ECONOMICS) tend to focus almost entirely on what government can do to stimulate or restrain aggregate demand in the short-run so as to even out the business cycle, supply-side policy analysts – while not necessarily going as far as SAY'S LAW (supply creates its own demand) – focus primarily on ways of expanding production. In this regard, supply-side economics stresses the importance of identifying ways in which the government can promote faster economic growth over the long haul by removing impediments to the supply, and efficient use, of the factors of production. Supply-siders believe that unwise provisions of the tax laws (and especially high marginal rates of personal and corporate income taxation) produce very damaging incentives that lead people to work less and to invest less (and to do both less efficiently) than they otherwise would.

Supply-side policies gained great favour with the Reagan administration in the United States during the 1980s and are often referred to as the basis of 'REAGANOMICS'. As implemented by that government, supply-side economics provided the general guidance for income-tax cuts, new expenditure priorities, monetary restraint and regulatory reform.

In one sense, supply-side economics is merely the application of price theory or microeconomics to the analysis of problems concerning economic aggregates or macro-economics. Its conceptual antecedents are to be found in the work of the classical economists of the modern era, from ADAM SMITH and J.B. Say through MILTON FRIEDMAN. As such, it represents no new body of theory; rather it entails addressing the neo-classical mode of analysis (see NEO-CLASSICAL ECONOMICS) to public economic policies, whether these are focused on concerns of the economy as a whole or on specific areas of economic activity.

In another sense, supply-side economics identifies several critical linkages associated with governmental actions. The initial effect of government actions is looked at in terms of the changes in relative prices (explicit or implicit) confronting households and businesses. It is the response by these private-sector entities to these relative price changes that determines the ultimate effects of the government actions. These responses involve changes in the allocation of existing production resources and claims on output which may result, more or less promptly, in changes in the total volume and/or composition of economic activity. In so far as volume changes occur, aggregate real income is also changed and this change in total real income will lead to further changes in economic activity. Since real aggregate demand is necessarily always equal to aggregate real income, these further changes in economic activity are depicted by changes in the components of aggregate demand. This sequence of effects, the precedence of price over income effects, is one of the critically important premises of the supply-side analysis.

Supply-siders often refer to the effect of government activities on relative prices as the 'first-order' effect and the consequences of private-sector responses as the 'second-order' effect.

Equivalently, the supply-side analysis points out that government actions first affect the allocation of resources and that one of the consequences of any such allocative effect may be a change on the level of economic activity. This mode of analysis similarly holds that these allocative effects of fiscal actions also largely determine the distributional consequences of fiscal action. However, the basic supply-side proposition denies the possibility that government action can initially and directly change the total real income of the economy. Instead, supply-side economics emphasizes that fiscal policy works by changing relative prices or incentives. High income-tax rates and regulation are seen as disincentives to work and production, regardless of the level of demand. Lower tax rates encourage saving, investing, working and risk-taking. As people switch into these activities out of leisure, consumption, tax shelters and working for non-taxable income, the incentive effects cause an increase in the market supply of goods and services – thus the name 'supply-side economics'. As people respond to the higher after-tax income and wealth, or greater profitability, incomes rise and the tax base grows, thus feeding back some of the lost revenues to the treasury. The saving rate also rises, providing more funds for government and private borrowing.

Specifically, supply-side economics focuses on two important relative prices. One governs people's decisions about how they allocate their income between consumption and saving. The cost to the individual of allocating a dollar of income to current consumption is the future income-stream given up by not saving and investing that dollar. The present value of that income-stream is influenced by marginal tax rates. The higher the marginal rate, the lower is the value of the stream. High tax rates make consumption cheap in terms of foregone income and the saving rate declines, resulting in less investment.

The other important relative price governs people's decisions about how they allocate their time between work and leisure or between leisure and improving their education and skills. The cost to a person of allocating additional time to leisure is the current earnings given up by not working or the future income given up by not taking courses to improve skills. The value of the foregone income is determined by the rate at which additional income is taxes. The higher the marginal tax rates, the cheaper the price of leisure. Absenteeism goes up, willingness to accept overtime declines and people spend less time improving their work skills.

Supply-siders argue that taxes like the progressive income tax work as a barrier to upward mobility and discourage people from making their best efforts. As a result, the tax system can make it more difficult for the average taxpayer to achieve financial independence. It is this barrier to success that supply-side economists attacked. The greater the extent of private success, the smaller the need for public assistance and the lighter the burden of government. Supply-side economics is not anti-government. It simply accepts the fact that the government is costly by nature and maintains that the greater the incentives and opportunities to earn income, the smaller will be the size and burden of government.

The application of supply-side analysis entails major changes in budgetary, fiscal and monetary policies. A fundamental implication of the supply-side analysis is that there is no pay-off in focusing fiscal policy on the control of aggregate demand. A corollary conclusion is that there is no valid purpose to be served by attempting to set government spending targets by reference to the supposed contribution of these outlays to aggregate demand. Similarly a policy focus on the total amount of tax revenues is inappropriate as a means of influencing the level or change in total economic activity. In the same connection, the size of the deficit should not be perceived as a relevant variable for policy manipulation in the interests of attaining designated levels or rates of growth in employment, output and income.

One of the major implications of these conclusions is that public economic policy should substantially forego short-run economic stabilization as a policy objective and focus instead on more attainable and more relevant

concerns. These include reducing (if not eliminating) government-induced misallocation of the economy's production capacity resulting from the distortions of relative prices produced by taxation, spending and regulatory policies. In consequence, the policy focus should shift to facilitating more efficient function of the private market system and to allowing the economy to achieve its potential growth over the long run.

Rejection of the aggregate demand approach in favour of the supply-side analysis leads necessarily to a change in the appraisal of the effects of fiscal actions on the price level. In the aggregate-demand analysis, tax and expenditure changes generate changes in aggregate demand which, since conditions of supply are deemed to be unchanged by fiscal actions, lead to increases or decreases in inflationary pressures. In contrast, the supply-side analysis delineates fiscal actions as impacting on aggregate demand in real terms only in so far as they first affect aggregate output by way of price effects. Thus an income-tax rate reduction, by virtue of its relative price effects, generates increases in output and in the supply of labour and capital services.

Rigorous application of the supply-side analysis leads to rejection of the view that budget deficits *per se* are inflationary or that increases in government outlays are the root cause of inflation. This view of budget deficits as a source of inflation rests on the observation that those deficits tend to be monetized. This is not an inherent or necessary consequence of budget deficits. Much depends on how the deficit originates. In so far as it results from tax or spending actions that depress or inadequately stimulate private-sector saving and is financed by a greater monetary expansion than would otherwise occur, this in turn may result in accentuation of inflationary pressures (depending on what the thrust would have been without the deficit). On the other hand, some fiscal actions (in particular supply-side tax reductions that reduce the relative cost of saving) are likely to generate a sufficient increase in private-sector saving to obviate the need for any monetary expansion to finance the deficit that such tax cuts produce.

A major policy prescription which flows from this analysis is that the traditional institutional link between monetary expansion and government deficits should be broken. Monetary policy should take the form of slow and steady growth in the stock of money, substantially oblivious to budget prospects or outcomes.

One of the principal analytical outputs of supply-side economics is the rejection of the so-called 'Phillips curve relationship' between inflation and unemployment. By the same token, it rejects the view that price-level stability can be purchased only at the cost of unacceptably high levels of unemployment or that acceptable growth in employment depends on pursuit of fiscal and monetary policies likely to spur inflation.

As noted, supply-side economics became particularly well known to the general public during the 1980s because of its advocacy by one influential faction of economic policy-makers in the Reagan administration, leading to the use of the term 'Reaganomics' to denote many of the ideas of the supply-siders. As implemented by the Reagan administration, supply-side policies were not designed to secure more revenues for the government or to balance the budget. Instead, these policies were directed towards overcoming the economy's inability to grow without increasing inflation and towards reversing the decline in the competitive position of the United States.

During the 1970s, productivity growth declined sharply. Policy-makers were confronted with worsening Phillips curve trade-offs between inflation and unemployment, ending in both rising inflation and unemployment – STAGFLATION. Also, in 1971, the US merchandise trade deficit turned negative; it grew dramatically during the latter part of the decade, despite the continuous fall in the dollar exchange rate.

Keynesian economists had great difficulty in explaining these developments and this failure created an opportunity for supply-side economists, who argued that the policy of pumping

up demand, while neglecting incentives to produce, had resulted in stagflation. As incentives eroded, each additional increment of demand called for less real output and more inflation. Supply-siders argued that improved incentives and lower costs imposed by government would result in a greater supply and more efficient use of productive units.

Keynesians have objected to the supply-side emphasis on relative price effects in fiscal policy. They have argued that decisions to work or save were either not affected by tax rates or were affected positively – that is, people would continue working or saving to compensate for the money lost to high taxes. They have also questioned whether incentives would be effective in time to deal with an immediate economic stabilization programme – that is, a recession or inflation.

Ultimately, then, the validity of supply-side versus Keynesianism is a matter of empirical fact. Here, both sides can muster up studies or economic developments supporting their positions. Supply-siders usually cite studies that show the responsiveness of saving, working and taxpaying to changes in tax rates. On the other hand, Keynesians usually point to the rapid growth in the fiscal and current account deficits during the Reagan administration as evidence of the absence of supply-side forces in the economy.

See also:

trickle-down

Further reading

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ROBERT LOONEY

surplus capacity

While undergraduates' micro-economic textbook treatments of 'surplus' or 'excess capacity' are often fairly straightforward (surplus capacity results when firms are producing on the downward portion, rather than at the bottom, of a U-shaped average cost curve), the concept is fraught with a number of conceptual and measurement problems. Ultimately, any definition of surplus capacity will be somewhat arbitrary.

First, surplus capacity must be defined in terms of some sort of measure of ideal or optimal capacity for a firm or plant. Specifically, is the aggregate capacity 'just right' in the sense of being present in such an amount as to supply the demand in the most efficient way? Or is there redundant capacity that raises costs above the minimum attainable level?

A second issue concerns the treatment of obsolete capacity in the measure of surplus capacity. In the usual industrial setting, plant capacity will be of various ages, states of repair and degrees of technical competence. A plant is properly considered obsolete, however, only when because of age, old-fashioned technology or other factors, the cost per unit of output for simply maintaining and operating the existing plant exceeds the alternative cost per unit of output for building as well as operating and maintaining a new plant. Even according to this strict definition, obsolete plant capacity does persist in some industries, though often on a 'stand-by' non-operating basis or with a very low rate of utilization. Again, how much of this type of capacity should be considered 'surplus capacity' is arbitrary.

The causes and consequences of surplus capacity are also varied. Large excess capacity may mean that an industry is holding prices too high. However, it can be caused by a number of other factors as well: the general level of economic activity may be low; sales may have fallen off because the industry's products are going out of style; excess capacity may be due to past investment errors in the industry or to anticipated increases in demand.