ARTHUR LAFFER AND THEORY OF SUPPLY-SIDE ECONOMY: A REVIEW

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Abstract

Supply- side economists are branch of economics that consider how to improve the productive capacity (aggregate supply) of the economy, unlike New Keynesians and Post-Keynesians, which are often concentrated on the side of aggregated demand. The purpose of this article is to analyze the teaching of the theory of economics of supply arising as a counterweight to Keynesians, on whose core is effective demand. The Economists on the supply advocate for an economy with huge tax cuts for individuals and corporations deregulation of business and a strong incentive for investment. Based on Say's Law, and supported by classical and monetary economists, it is still opposed to Keynesian (the demand side) economy which theorized that aggregate demand is the primary driving force and strength of stabilization in an economy. Also subject to elaboration in this paper will be Laffer's curve. Arthur Laffer. He has its own contribution to the extreme claim that the government can reduce tax rates without losing money. In fact, if anything, the government will probably get higher tax revenues *after* the reduction in tax rates. But this view was not supported by empirical evidence about the elasticity of tax at that time by some economists.

Keywords: supply-side economy, tax rates, revenue, Laffer Curve.

1. Introduction

The name of this doctrine was first mentioned in the speech of Congressman J. Camp in the US (1979). According to another interpretation, the term was first used in 1976 by Stein (American expert on budgetary policy). Supply-side Economics is also found under the name theory of supply economics. The reason of occurrence and expanding of Supply-side economics should be sought in the unfavorable economic trends in developed countries in the 1970s of the XX century, as well as unfavorable Keynesian economic policy. In essence, the concept of the supply side economics proposes restoring neoclassical principles, an opponent of these principles was Keynesian theory.

In the late 1970s and 1980s, a relatively small group of economists, also assumed that the business cycle was the result of fluctuating aggregate supply. However, their view was that government policies were responsible for the disruption of aggregate supply in the economy. They argued that the government should create an environment that is hostile to business success, and that encourages waste and inefficiency, resulting in a shift to the left in aggregate supply curve. Shift to the left in aggregate supply curve leads to higher unemployment and inflation at the same time and this was their explanation of stagflation in the 1970s. This theory was never widely accepted in the economy, although it was used by conservative politicians and serves as the basis for the economic policies of Ronald Reagan (Reaganomics). *It could say that the economy of the supply is considered as*:

- The concept of change, or improvement of the economic policies of the advanced industrial countries in the field of taxes and public spending that would compensate any negative effects of the Keynesian theory of economic policy, than
- A special direction in the development of economic thought. Good tax policy leads to a redistribution of the national income in favor of the close-up capital, to increase the marginal propensity to savings at the expense of spending and conservative socio-economic changes and effects, whose long-term consequences of a negative character. The economics of supply may provide short-term positive effects (Todorov, T. 2002).

2. Literature review

A survey method will be used. For the writing of this paper is consulted literature from the field of the history of economic thought and economic theories. Specifically, has been researched the thoughts of economic supporters of the theory of economics of supply. For this purpose, the subject of analysis was their scientific contribution in writing of books and certainly scientific papers in the appropriate field. I personally believe, that understanding the different approaches and perspectives on the economy, the reasons for these differences and how they evolved over time, provides a historical and philosophical context that encourages most economists to use critical analysis of current economic tools and their application. This critical approach has three advantages. First, in many industrialized countries and developing countries, the study of the history of economic thought is considered as an indispensable part of the training of any economist or compulsory subject of each student. Second, new research and new knowledge of modern economists are based on existing knowledge gained from the study of the history of economic theories. And third, the contribution will be in the scientific thought of all that new knowledge that will always have a basis and a tendency to set up and study of new economic theory.
In this context, the economy of supply starts from the fundamental principles of neoclassical macroeconomic theory, including Say's Law of markets. Supporters of the economics of supply at the centre of studies put the aggregate supply (production of goods and service). It is believed that the increase in supply will cause the rise in demand and thus will balance the market and the most efficient mechanism for allocating resources. In many papers, economists stress the need to seek ways to stimulate the growth of supply as a means to regulate economic trends, and as one of the important means to achieve this objective they perceive in the increasing freedom of private initiative and entrepreneurship. Furthermore, prevalent view in the conducted research is that, increasing employment and reducing inflation can be achieved by reducing tax rates, which will cause more initiative and

motivation of companies and individuals to increase investment activity and increased of production growth. And as far as the economic policy measures needs to focus on general and big tax cuts, especially taxes on rich people, then reducing public expenditure on social welfare, reforming the tax system of the United States aimed at reducing sharpness of tax progression and more. Lastly methodological research point to the conclusion that priority is given to economic growth and production and economic policy measures need to focus on supply.

2.1 Arthur Laffer and theory of supply side economics

According to supporters of the supply side, the liberal government policies during the late 1960s and early 1970s have reduced output and employment in the United States with excessive taxation (especially businesses) and excessive regulation. These excessive taxes and regulations have increased production costs of US businesses and inflict on them to reduce output and employment. Individuals who have worked hard, have gained additional training or education and their salaries have been increased, but suddenly they found in higher tax brackets where they lost a greater percentage of their income to the government. These activities that are valuable to the economy and society simply discourage people in implementing. In addition, the Government was told to encourage losses and inefficiencies by rewarding unproductive behavior - tax category a large write-offs of excessive spending and approval of programs "reward" people for choosing not to work or to acquire skills through giving benefits such as welfare and food stamps. In general, the Government was told to create a distorted incentive system where the productive behavior will be punished and discouraged, while unproductive behavior will be rewarded and encouraged (Nikoloski & Paceskoski, 2016).

Solution to this on the supply side was to reduce taxes, especially for businesses and upper income groups, reduce government regulations in the industry and to reduce the approved eligible costs. Therefore, this theory had a special significance for political conservatives. While many conservative economists were inclined to some of the claims on the supply side, their theory has been largely rejected in the economy because of the extremes in their claims. The most controversial aspect of the model on the supply side was their view of the relationship between tax rates and government tax revenues. From a scientific perspective, the reduction of corporate tax allows more money for the businesses sector to hire workers, invest in capital equipment and to produce more goods and services. This increase in supply leads to increased economic growth (Stojkov, 2008).

Supply-siders also believe that reductions in marginal tax rates increase aggregate supply. They believe in the Laffer Curve, which says that up to a certain point in tax rate, tax revenue increases, and at that point, tax revenue is a maximum. However, when taxes go past that point, tax revenue starts to decrease again. Criticisms of the Laffer Curve include

- evidence that tax cuts don’t necessarily increase incentive to work,
- inflation might still occur because AD might overwhelm AS, and
- No one knows where we are on the curve.

2.2 The research of Arthur Laffer

Arthur Laffer was born August 14, 1940. He is an American economist who first gained prominence during the Reagan administration as a member of Reagan's Economic Policy

Advisory Board (1981–1989). He is the author and co-author of many books and newspaper articles, including *Supply Side Economics: Financial Decision-Making for the 80s*.
Special role and significance for the occurrence of the economy of supply has his famous "Laffer curve." Invented by Arthur Laffer, this curve shows the relationship between tax rates and tax revenues collected by the state. In this connection Arthur Laffer writes: The theory of supply in her essence is part of the economic theory, which focuses its attention on the personal and private incentives and motives. The main idea consists that people do not work just to pay taxes. Operating they rely on what will be left after paying taxes. They save to not go to bankrupt (Бекјарова, К., Велев, Б. & Пипев, И. 2007).
The curve shows that, as taxes increase from low levels, tax revenue collected by the government also increases. It also shows that tax rates increasing after a certain point (T *) would cause people to not working as hard or do not work at all, thereby reducing tax revenue. Eventually, if tax rates reached 100% (far right on the curve), then all people would choose not to work because everything they earned would go to the government.
In ceteris paribus, the tax rate and the tax base will move in the opposite direction. If the Government increased the tax rate it results in to discouragement of production or consumption of goods that are taxed. The extent to which production and consumption decline depends on the reaction of people who are taxed. The more consumers keep buying a product, even though it is now more expensive, the more manufacturers will continue to produce the same. As a result, the tax base will shrink less than the elevated tax rate and tax revenue will move forward with a tax rate. If people tend to continue to work, despite an increase in income tax, then the tax base declines less than the elevated tax rate and tax revenue will again move to tax rate. How much less consumers keep buying a product because it is now more expensive, less manufacturers will continue to produce the same. As a result, the tax base will decrease on figures from the increased tax rate and tax revenues will move to the tax base. If people tend to not continue to work because of the increased tax revenue, the tax base declines more apart from the increased tax rate and tax revenue will again move to the tax base. Given that tax revenue is the product of the tax rate and the number of units are taxable (tax base), the equation would be as follows:

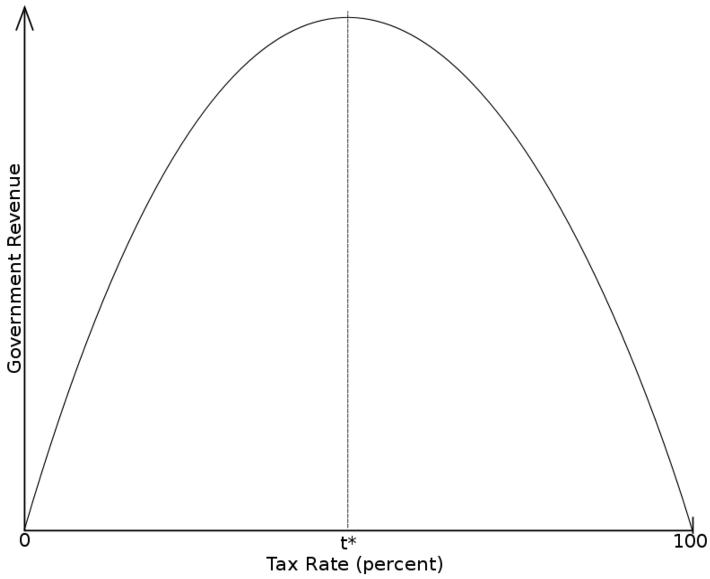
$$\text{Tax Rev} = \text{Tax Rate} \times \text{Tax base}$$

When the tax rate is 0%, then it is clear that the government will take \$ 0. But it can be noticed that the government also takes \$ 0 when the tax rate is 100%. The question is whether people will work or will open new businesses, if the government takes 100% of their revenue or profit?
Amid lower tax rates, the tax base will significantly decrease with increasing tax rates. People are not going to change their behavior when very low tax rates will rise to lower tax rates. At higher tax rates, the tax base is significantly reduced by increasing tax rates. Many people will change their behavior when high tax rates will become even higher. These are known as *prohibited taxes* - tax rates are so high that will reduce tax revenues.

2.3 Discussion

The discussion related to Laffer curve lead us to the conclusion that, reducing of taxes will contribute to increased productivity and national income. In such a case and in the lower tax rates could provide increased public revenues. And it will further contribute to reducing inflation, overcoming the economic crisis and ensuring balanced economic growth with full employment. Also, the reduction in tax rates can lead to increased savings, which in turn will increase the investment, and consequently will increase the production and supply. Accordingly, the rich are those who save more and invest more.

Graph1. *Laffer curve*



The essence of the discussion about Laffer curve consists of the following:

- If the state does not impose taxes, then there will be no budget revenue;
- With the increase in tax rates increase budget revenues;
- By increasing the tax rates are reached the maximum, and then discourages economic activity and reduce public revenues (point A on the graph) and,
- If the tax rate is 100%, there will be no revenue in the budget, because such a rate means de facto confiscation. So, the optimal tax burden is between zero and 100%.

1. The story behind the Laffer Curve

The Laffer Curve earned its name from a 1978 article by the late Jude Wanniski (then-associate editor of the *Wall Street Journal*) appearing in The Public Interest entitled, “Taxes, Revenues, and the ‘Laffer Curve.’” Wanniski recounted a 1974 dinner he attended with Arthur Laffer (the professor at The University of Chicago), Donald Rumsfeld (chief of staff to President Gerald Ford), and Dick Cheney (Rumsfeld’s deputy and a former classmate of Laffer’s). When the foursome’s dinner discussion turned to President Ford’s “WIN” (Whip Inflation Now) proposal for tax increases, Dr. Laffer is said to have grabbed his napkin to sketch the curve as an illustration of the tradeoff between tax rates and tax revenues. Wanniski dubbed the tradeoff described as the “Laffer Curve.” As to Wanniski’s recollection of the story, Dr. Laffer has said that he cannot remember the details, but he does recall that the restaurant where they ate used cloth napkins and his mother had taught him not to desecrate nice things. He notes, however, that it could well be true because he used the so-called Laffer Curve all the time in classroom lectures and to anyone else who would listen. Although the Laffer curve bears his name, the ideas behind it were not new or his alone. In fact, Dr. Laffer likes to point out that the ideas are so straightforward that people knew about it hundreds of years before. For example, the Muslim philosopher, Ibn Khaldun, wrote in his 14th century work, *The Muqaddimah*: It should be known that at the beginning of the dynasty, taxation yields large revenue from small assessments. At the end of the dynasty, taxation yields small revenue from large assessments (http://www.laffercenter.com/the-laffer-center-2/the-laffer-curve/).

Conclusion

As economic policy, this theory of the economics of supply contributes to increased employment. For example, in Ronald Reagan's economic policy it was opened about 20 million new jobs, inflation was reduced to a tolerable level, and more. But while unemployment saw a significant increase, and the budget deficit reached a record level. Based on the economics of supply is proposed certain economic policy, such as: reduction of marginal tax rates, primarily taxes on income, with purpose to encourage private initiative to increase the supply and to overcome stagflation; and reducing tax exemptions, mitigation of tax progression, reduction of social transfers, stimulating entrepreneurship and others. Regarding the criticism of the economics of supply-side by economists of other schools as the most important we find:

- Some thinkers believe that it seeks to address the weaknesses of Keynesian and monetarism and thus contribute to solving the problems of stagflation. For example, in the fight against inflation it stands to regulate the money supply (and monetarists), but also to influence demand (as Keynesian).
- The criticism says that Laffer is not specifically express the turning point at which higher tax rates will cause a reduction in the absolute size of tax revenues. Some believe that this point is 50%, while others find about 80%
- Supply economics has been criticized largely because of the proposed means for achieving the goal. For example, Paul Sweezy and Harry Magdoff think it comes down to a request for redistribution of income in favor of the rich and at the expense of the poor.

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