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The entrepreneur

The Belden Center for Private Enterprise Education
Harding University School of Business

This issue courtesy of Mr. Steve Phillips, Phillips Lumber Co., Inc., Cedar Hill, Texas

A Rising Tide Lifts All Boats

Director Receives Three Awards From Freedoms Foundation

Dr. Don Diffine, associate professor of economics and Director of the Belden Center for Private Enterprise Education at Harding University, has been named the recipient of three 1980 Freedoms Foundation awards, including the Award for Excellence in Private Enterprise Education.

Dr. Diffine's awards were announced at the Valley Forge National Headquarters of the Freedoms Foundation on Washington's birthday, February 22, along with other principal awards.

The Private Enterprise Education award was presented to Dr. Diffine during a special ceremony in Valley Forge, Pennsylvania, May 8. On that occasion, Diffine was awarded a $7,500 check and a plaque attesting to his achievement.

Dr. Diffine was also presented a Valley Forge Honor Certificate Award recognizing his editorship of the "Entrepreneur," a quarterly newsletter released by Harding's Belden Center for Private Enterprise Education, which is under Diffine's direction. The Belden Center also received an award for the nonprofit publication.

Diffine has taught at Harding for 10 years. In addition to coaching the economics team, directing the Belden Center and editing the "Entrepreneur," he conducts business and economics seminars for educators, executives and opinion leaders.

The author of several scholarly articles, Diffine has testified before a Congressional subcommittee on economic matters and has served as a consultant to various businesses. As the winner of six previous Freedoms Foundation awards, he is listed in "Personalities of the South" and "Outstanding Educators of America." He is a charter member of the Association of Private Enterprise Education.

by

David Tucker
Assistant Professor of Economics
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A racquetball friend of mine was having trouble with his taxes. Since I work cheap, he asked me to come over one night and help. I arrived and started filling in the little numbers in the little boxes. When we finished adding, subtracting, adjusting and crediting, he and his wife found that they owed an additional $500 in taxes. Faced with this amount, his wife stated, "Well, that does it. I'm just not going to work this summer!"

I doubt very seriously that she knew it, but she had just captured, in one little sentence, the essence of supply-side economics.

RELATIVE PRICES

From the supply-side viewpoint, all governmental actions change relative prices. Remember that phrase "relative prices." It's the key. One quick example. If the government were to grant a tuition tax credit to private schools, would that make the price you pay for sending your son or daughter to Harding relatively more expensive or relatively less expensive? Less expensive, obviously. Why? Because it reduces the amount of tax you pay.

The tax credit does not raise the general level of prices. An increase in the general price level is called inflation, and inflation is caused by the excessive growth of the money supply relative to the growth of goods and services.

A technical quote from an expert would be appropriate here. Norman Ture is now Undersecretary of the Treasury for Tax Policy. He is one of the founders of the philosophy called supply-side economics. On May 21, 1980, he testified before the Joint Economic Committee of Congress and stated, "The distinctive characteristic of the 'supply-side' analysis is that it identifies the initial effects of tax or other fiscal actions

in terms of the changes in relative prices these actions entail and seeks to describe and measure how households and business respond to these relative price changes. These responses are likely to take the form of changes in the total amount supplied of one or another production input . . ."

If governmental policy does indeed change relative prices, then there are an enormous number of relative prices being changed. Let's look at a few.

Tax deductions are the easy ones to spot. By being able to deduct the interest payments on your home mortgage, housing becomes relatively less expensive. By being able to deduct charitable contributions, your contribution to Harding University is relatively less expensive. By being able to deduct a certain portion of medical expenses, medicine and drugs are not so expensive. The energy tax credit makes it easier to insulate your home.

These are obvious examples that are easy to understand. The government has deemed certain activities more useful than others and has therefore blessed these activities by lowering their price. The moral question of whom the government is to bless or curse certain activities through the tax code is interesting, but not relevant to this discussion.

TAX RATES

But these are specific examples. What about personal income tax rates themselves? Remember, supply-siders believe **all** governmental actions change relative prices. How does the present tax rate structure change relative prices?

First of all, remember that personal income tax rates are marginal and progressive. The marginal tax rate is the rate which is applied to your next dollar of taxable income. Put another way, if you were to earn an additional $1,000 in income this year, the marginal tax rate is the rate applied to the additional income. Progressive tax rates mean that as your income increases, your tax rate will increase.

The result of progressive marginal tax rates is that as you work harder and make more before-tax income, you are simultaneously being taxed more and receiving relatively less income after-taxes. You may work harder, make more money, but you receive less and less for your effort. The link between productive work effort and reward (after-tax income) is being weakened. There is a wedge being driven between work and after-tax income. And that wedge is progressively higher marginal tax rates.

It was the philosopher Slats Grobnick who said, "If work's so great, how come they gotta pay you to do it?" Well put, Slats.

Why do people work? They work, or produce, to receive the rewards of work effort. People work and produce, in the words of Jack Kemp, "for after-tax income, after-tax profit, after-tax rewards."

Apparently, the tax system is designed to stifle work effort. As a result, some individuals decide that the price they receive for their effort is not worth the trouble. They simply opt out of the system. Remember my friend's wife?

Not only do high tax rates influence work effort, but they have also influenced career decisions. We now have, in the United States, a vast army of accountants, lawyers and analysts who do nothing but avoid taxes. We have highly-intelligent and highly-motivated individuals who do nothing but think about new ways to avoid taxes.

How much better off would society be if our behavior were not shaped by taxation? How much better off would we be if we could forget about tax avoidance and fully concentrate on productive activity?

GOVERNMENT SPENDING

So far, we have been discussing the relative price changes which are caused by the tax system. We have noticed how the revenue gathering arm of the government discourages production and productive effort. Let's not forget the relative price changes caused by government expenditures.

Basically, there are two types of government expenditures. One is defense. The second is transfer payments or what President Reagan calls "social safety net" programs.

If defense spending increases, the obvious result will be an increase in the relative price of defense related goods. Indeed, after Reagan was elected, the newspapers reported increases in the stock prices of defense related industries.

The original idea of the transfer payments was to provide a cushion to help ease the trauma of not being able to provide for yourself. I don't think that food stamps and welfare were meant to be a permanent subsidy to an oppressed class. Indeed, most articles which quote welfare recipients say that the recipient would very much like a productive job.

In 1965, 24 percent of the Federal budget went to transfer payments. This compares with over 40 percent today. In terms of national income, transfer payments have also increased dramatically. In 1965, 7.1 percent of national income went to people who did not earn it in the current period. In 1975, this amount had increased to 14.5 percent.

So the welfare roles are expanding, not shrinking. Why? Jack Kemp, in his book **American Renaissance** provides a clue:

> The problem today is that if welfare recipients take a job, their benefits (including Medicaid, food stamps and housing allowances) are stripped away, they face commuting and other related expenses, and federal and state governments impose hefty income and payroll taxes on their earnings. The net effect, documented in numerous studies, is that the family is often worse off if its head accepts an

entry-level job — that is, the marginal tax rate on added earnings exceeds 100 percent.

The trend is clear. As earnings rise, assistance falls and taxes rise. As earnings fall, assistance rises, and taxes fall. Catch-22.

So what is the economic result of the high tax rates and transfer payments? The result is that productive effort is discouraged and leisure is encouraged. The production of goods and services is discouraged. The **supply** of goods and services is discouraged.

ROOTS

We have dealt with the philosophy called 'supply-side' economics from the viewpoint of the tax-expenditure system of the Federal government. And that is the proper starting point for our discussion since it seems taxes and government expenditures do so much to discourage supply.

However, Solomon has told us that there is really nothing new under the sun, and supply-siders will confess that they borrowed largely from the past.

Supply-side economics has its roots in an economic principle first espoused by the French economist Jean-Baptiste Say. The principle is called (surprisingly) Say's Law and it simply states that "supply creates its own demand."

Since the days of FDR, political and economic thought in the United States has been a reaction to the Great Depression. Prior to the Depression, Say's Law was generally accepted by economists and politicians. However, the Depression was a profound economic event, and the public perception of who or what caused it has had a profound effect on political voting habits.

The economist who most people believed properly explained the Depression was John Maynard Keynes. Keynes believed that the Depression was a failure of the free market system. More specifically, he stated that the Depression was due to a lack of 'effective demand.' He therefore contested Say's contention of the supremacy of supply.

Keynes measured effective demand by its three sources. Consumer spending, investment spending, and governmental spending. Since, in his view, the free market had obviously not generated sufficient consumer and investment spending to purchase existing supply (primarily the supply of labor), then government must step in and supplement the free market and guide the free market to full employment. In practice, this analysis takes the form of the CCC, the WPA, etc.

Democrats have been using the Keynesian philosophy to justify ever increasing amounts of government spending. And they have been the primary political party using this ideological banner.

But during the late 1960's and 1970's there arose two vexing problems not explained by Keynes. The problems are inflation and economic stagnation. Remember, Keynes did not worry about inflation during the Depression. He was faced with deflation and massive unemployment.

So the Democrats have a problem. Their economic mentor has left them with a system unable to cope with current economic problems. The philosophy which Ed Bethune, Republican congressman from Searcy, calls the "tax-spend-regulate mindset" no longer works. Where do we turn?

We return, simply, to our roots. We return to the supply side.

THE REAGAN PROGRAM

The core of President Reagan's tax program is a 30 percent, across-the-board cut in personal income tax rates. These cuts, according to the proposal, will be phased in over a 3-year period. The intended result is to eliminate all of the disincentives we've just talked about. Will it work? Yes, of course, to a great degree. But there are still several other questions we need to discuss.

There are two basic arguments being voiced against cuts in tax rates. The first has to do with the loss in government revenue, and the second argument asserts that the poor will be forced to shoulder a heavier tax burden as a result of the tax rate cut.

To answer the revenue loss argument: Non-supply-siders are confusing a reduction in tax **rates** with a reduction in tax **revenues.** Their argument goes something like this. A big tax cut causes a big drop in revenue to the government. This causes the budget deficit to increase. Because the deficit increases, the Treasury must borrow more and more money to cover the deficit. This additional demand for debt forces up the rate of interest and crowds many private borrowers out of the credit markets.

On the other hand, the additional Treasury borrowings (borrowings necessitated by the deficit, caused by the tax cut) could be purchased by the Federal Reserve system. This causes a direct increase in the supply of money, and here we have, again, too much money chasing too few goods: inflation.

How do supply-siders respond to the revenue loss question? We respond by simply looking at history. Across-the-board tax cuts, like President Reagan's, have occurred twice before in America. In 1922-25 and 1964-65.

In 1921, because of World War I, personal income tax rates ranged from 4 percent to 73 percent. President Harding began in 1922 to cut tax rates and this process was continued during the Coolidge administration. Silent Cal didn't ever say much, but when he did, it was worth listening to. Here's what he said, "Taken altogether, I think it is easy enough to see that I wish to include in the economic program a reduction in the high tax rates, not that small incomes may be required to pay

more and large incomes required to pay less, but that more revenue may be secured from large incomes and taxes on small incomes may be reduced."

There's the answer. If you cut tax rates in the lower tax bracket, the people use the money for consumption. They increase their standard of living. Therefore, tax revenue from the lower brackets will be less after the tax cut.

But what about the cuts in the higher tax brackets? The higher income people don't need additional consumption; and since more investments are now profitable, they invest more, and make more income. The higher income people will end up paying **more** in taxes than before the rate reduction.

It's a great plan for the poor people. They will not shoulder a heavier tax burden. In fact, their burden is reduced. And we can finance the reduced burden for the poor by decreasing tax rates for the rich.

INCOME DISTRIBUTION

There are no politicians or economists who would like to see poverty in America. There is great debate, however, as to how it is possible to achieve a more equal distribution of income and wealth, and what role should the government play in any distribution?

A supply-sider would say that it is the function of the government to create an environment of incentives or a set of relative prices such that economic growth is possible. We must increase the size of the economic pie so that everyone can have a bigger piece. The key is growth.

The last across-the-board tax cut was proposed by John Kennedy, and passed after his death. I think it is somewhat ironic that both rich and poor, supply-siders and Keynesians, point to Kennedy as a truly great leader. He understood growth. He understood that high tax rates discourage more than they produce. Listen to a few of his quotes.

> In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low — and the soundest way to raise revenues in the long run is to cut tax rates now. The central purpose of tax reform is to encourage economic growth and the flow of capital. For it is increasingly clear — to those in government, business and labor who are responsible for our economy's success — that our obsolete tax system exerts too heavy a drag on private purchasing power, profits, and employment. Designed to check inflation in earlier years, it now checks growth instead. It discourages extra effort and risk. It distorts the use of resources. It invites recurrent recessions, depresses our federal revenues, and causes chronic budget deficits.

Ed Bethune has explained supply-side economics this way:

> The upcoming effort to reduce taxes, government spending, government lending, and government regulation is an effort to restore economic freedom to the people. If adopted, it will change the tax-spend-regulate mindset that has gripped us for decades. It is an effort to restore incentive to workers, producers, savers, and investors, thus promoting economic growth.

I recall Kennedy's most famous line which uses the sailing analogy he loved so much, "A rising tide raises all boats."

EPILOGUE

The supply-side analysis is controversial primarily because it involves a change in a way of thinking. It looks at events differently and is therefore easily misunderstood. It was my purpose to try to correct some of that misunderstanding. If you can say, as Treasury Secretary Reagan recently said, "I was a supply-sider before I ever heard the term," then this article has been worthwhile.

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