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PILLARS OF SUPPLY SIDE ECONOMICS

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The classical model of economics consists of principles derived through centuries of social and commercial experience. Adam Smith's *Theory of Moral Sentiments* (1759) and *Wealth of Nations* (1776) advanced the process of opening commercial society to analysis and insight. Under the "supply side economics" *nom de guerre* assumed in the last quarter of the 20th Century, classical economic theory continues as it began. It undertakes to identify principles of human conduct in commercial relations, and to apply these principles in analyzing and predicting economic conditions and in designing public policy.

Classical economics is valuable for its clarity, for the demonstrable validity of its principles, and for its utility in interpreting and forecasting economic conditions. That being the case, classical (supply side) economics is particularly helpful in identifying errors of competing economic models used commonly in academia, financial media and political circles. A synopsis of pillars of the classical economic model follows, first relating to fiscal policy and then to monetary policy.

The Laffer Curve

Thirty years have passed since Arthur Laffer drew on a napkin in a Washington, D.C., restaurant the curve that depicts how tax revenues rise and then fall as the tax rate rises from zero to 100%. The Laffer Curve is renowned for its simplicity in reflecting a principle of taxation so important to public policy: *every practical level of government revenues can be produced by two tax rates, one lower than the other.*

Another way to state the principle is as a rule of diminishing returns: every tax has a rate that produces

maximum revenues and, if the tax rate is raised higher, revenues actually diminish.

The Laffer Curve is widely acclaimed as a teaching tool partly because its two underlying premises are so self-evident. The first premise is that tax revenues will be zero when the tax rate is zero. The second premise is that tax revenues will also be zero when the tax rate is 100 percent. This second premise requires only a bit of explanation that all economic activity will cease when taxes take all of the proceeds, so zero activity produces zero taxes.

Therefore, we can be sure that raising the tax rate above zero percent will produce higher tax revenues until some point of maximum revenues is reached. If the tax rate is raised higher, total tax revenues begin falling towards zero as the 100% rate is approached. The Laffer Curve traces the rising and falling revenues as the tax rate rises from zero to 100%.

Art Laffer would likely be the first to acknowledge that this economic insight did not originate with him. Alexander Hamilton wrote in 1782 "... experience has shown that moderate duties are more productive than high ones."¹ Hamilton was likely drawing on experiences recorded in earlier writings of Adam Smith and others. So the Laffer Curve is a long-standing principle of classical economic theory, though it was given its current name by Jude Wanniski, as classical economics was renamed supply side economics in 1976.

With two tax rates capable of producing the same amount of revenues for government operations, which rate should be chosen? The taxpayer urges, of course, that the lower tax rate is best because it leaves more money in the hands of the person who earned it. Are there additional reasons to choose the lower tax rate as a matter of public policy?

If the economy were truly a zero-sum game, one might think the higher tax rate would discourage the wealthy from "taking a bigger slice of the pie," leaving more for others. Some may argue that paying the higher tax rate is

¹ *Alexander Hamilton*, 170, Ron Chernow (Penguin Press, New York 2004).

akin to a civic duty, and that higher tax rates create a greater sense of community and of sacrifice.

But zero-sum thinking is thoroughly discredited. Greater production by one person does not preclude another from being more productive, even when the two must compete against each other. Competition benefits both producers and consumers, as the successful competitor must improve the efficiency of production and the quality of goods and services.

The lower of two tax rates capable of producing the same total tax revenues should always be chosen, for two primary reasons. The lower tax rate will produce a higher rate of employment, and a higher rate of economic growth. These two principles, like the Laffer Curve, can be illustrated by simple graphs.

Employment vs. Tax Rate

First, consider how employment varies with the tax rate. If ever full employment occurs (*i.e.*, every person available to work has a job), it will be at a tax rate near or equal to zero. *Employment approaches 100% as the tax rate approaches zero.*

Indeed, the pool of employable workers actually expands as the tax rate drops. As the "tax wedge" of payments demanded by government diminishes to nothing, workers emerge from the hidden economy and are detected in formal employment records. Such workers have no motive to remain "under the radar" in their productive activities when no tax cost is associated with detection.

On the other end of the tax rate spectrum, *the employment rate begins to fall and approaches zero as the tax rate rises towards 100%*. No one will invest capital to employ another if the government takes all profits as tax. This premise is equally as valid as the Laffer Curve's postulation that tax revenues fall to zero at the 100% tax rate. If a tax rate of 100% produces zero tax revenues, surely the employment rate is zero as well.

Graphing this relationship with the employment rate on the vertical axis and the tax rate on the horizontal axis, the employment rate begins near 100% at the zero tax rate

and declines to zero at the 100% tax rate. The curve has the general appearance of a quarter-circle spanning from the point of 100% employment to the point of 100% tax rate. Between the minimum and maximum tax rates, the slope of decline in employment may vary depending upon social factors such as whether wartime or peacetime conditions exist, and economic factors such as available capital and monetary conditions.

This graph illustrates the principle of an *inverse* relationship between the employment level and tax rates. As *the tax rate rises, the employment rate falls*. The lower the tax rate falls, the higher the employment level will be. This benefit to the economic well-being of the community is a significant reason for choosing the lower of two tax rates.

If this second principle of classical fiscal theory seems near to being a truism, so much the better. As such, it is a near-truism often ignored in the making of public policy. *Every tax increase costs jobs*. The reasoning is irrefutable. Yet the point needs to be made more precisely when legislatures seek to benefit society.

GDP Growth Rate vs. Tax Rate

Consider the relationship of the tax rate to the rate of economic growth. Again we begin with the tax rate of zero to 100% on the horizontal scale. The first and second principles of classical fiscal theory establish that, when the tax rate is zero, tax revenues will be zero and employment will be at or near 100%. Thus, at the zero tax rate, the rate of economic growth will reach its maximum coincident with full employment.

As the tax rate rises, the economic growth rate falls, first to zero and then towards increasingly negative rates. A maximum rate of economic shrinkage is approached as the tax rate reaches 100%. Again, the precise shape of the curve between the minimum and maximum tax rates would differ with circumstances. The important principle is that the economic growth rate falls sharply as the tax rate rises. *The lower of two tax rates will achieve a higher rate of economic growth every time.*

Now we have a second significant reason public policy should choose the lower of two tax rates. The lower tax rate allows a higher rate of economic growth. *Every tax increase cuts the rate of economic growth.*

Classical Theory in Tax Policy

Classical economic principles add measurably to the debate of tax policy. Higher employment is quickly and correctly associated with an improving standard of living. Higher economic growth rates are correctly associated with faster accumulation of capital. Increased capital is coincident with a higher standard of living. Increased capital provides more efficient equipment and technology, higher productivity growth, higher wage rates, increased production and further accumulation of capital.

Some argue against tax rate cuts because there is uncertainty where two rates fall on the Laffer Curve. The higher rate may already be on the low side of the curve, they fear, so selecting the lower rate may reduce revenues as well as rates. Thus, they argue against any reduction of rates on grounds that public revenues may shrink.

These arguments are insufficient to control the debate of tax policy. *When the merits of two tax rates are weighed, the lower tax rate may produce equal or higher total revenues and will definitely allow higher employment and faster economic growth.* With that trade-off on the table, the lower tax rate is highly persuasive in every case except when essential public needs cannot otherwise be financed in the short run.

Stability of the Monetary Unit

Classical economic theory of monetary policy is built upon a single, fundamental principle: *the value of the currency unit should be stable.* This principle is derived from the essential role of currency in commercial society.

Currency's role is to serve as a fungible store of value readily exchangeable for goods and services. Currency thereby increases commercial efficiency by permitting transactions without bartering one type of wares for another. A currency with known, stable and reliable value empowers each party to gauge the fair price of each

product, and to pay or receive that price without hesitation arising from concern for currency deterioration.

A currency deteriorates when its value changes, either by decreasing or by increasing. Change in value damages the currency by inhibiting its utility in commerce. With any change in value, the currency immediately becomes suspect as to its future value, reliability and stability. Suspicion of monetary stability is a friction or irritant in commercial transactions that reduces efficiency and slows economic growth.

Currency deterioration damages the economy by hurting confidence in the currency, but that is only the beginning of its harmful effects. A currency in general use plays a central role in the lives and operations of every individual and enterprise. Trillions of judgments have been made throughout the world, measuring the value of goods, services and properties of every variety and setting prices in the monetary unit of the currency. *If the value of the monetary unit changes to any degree, every one of those trillions of judgments must be adjusted if the parties and items affected are to maintain the values previously determined.*

The burden of adjusting prices, wages and other values in terms of a deteriorating currency must be addressed urgently by every affected party. Otherwise, damage can be significant and drastic. Unfortunately, much of the damage is unavoidable, because currency deterioration ordinarily is unannounced and unobtrusive.

When the currency deteriorates by increasing in value, the currency effectively adjusts upwards the value to be received through any previously set wage or price. A producer of goods or services must reduce previously set prices or his wares will not sell. Customers will have fewer dollars if each dollar is more valuable. But reducing those prices will reduce profits and may even incur losses considering costs of production. Wages are not easily reduced, and job elimination may be the only alternative to reduce costs. Unless costs are adjusted to suit new conditions of pricing and demand, business profitability will fail.

When the currency deteriorates by falling in value, the value of goods, services and property likewise fall in value unless prices and wages are proportionally increased. Each party in the market must make these adjustments or be punished accordingly through loss of value. A business must raise prices or face losses as its employees and suppliers require increased wages and prices to maintain their own purchasing power.

A weakening, inflating currency is a reality that cannot be ignored, as is a strengthening, deflating currency. This is why currency deterioration accurately describes defective monetary policy, regardless of whether the value of the monetary unit is rising or falling.

When time and talent are applied to adjusting wages and prices due to currency deterioration, more productive work is ignored. This is no small concern, since each person and firm must deal constantly with wage/price adjustments of every item owned, bought or sold.

By comparison, filing income tax returns requires record-keeping and preparation of annual tax returns. The efforts expended in those tasks have been estimated as equivalent to 10.2 billion hours for 1995, or 5.1 million full-time workers. The auto and aircraft industries combined employ only about 1.4 million workers. The annual cost of U. S. tax compliance during the mid-nineties was estimated to be \$225-\$300 billion.²

The value to an economy of a stable currency is quite substantial, far exceeding the mere cost of hours spent adjusting to perceived fluctuations in value. Life's concerns are complicated in many ways when currency value changes. The complexity is not eased by the difficulty of predicting, measuring or anticipating such value fluctuations. Economies freed of such complexity fairly fly past the slogging performance of those laboring under the burdens of unstable currencies.

² Testimony of James L. Payne, "Replacing the Federal Income Tax," Hearings before the Committee on Ways and Means, House of Representatives, June 6, 7 and 8, 1995, Serial 104-28, pp. 183-187. Also, see James L. Payne, *Costly Returns: The Burden of the U. S. Tax System*, ICS Press (San Francisco, 1993).

Measuring Currency Value

Putting aside the international monetary system since 1971, the time-honored measure of a currency unit's value is the number of units required to buy an ounce of gold. This being the case, the most reliable and accurate signal of a currency's value at a given moment is the price of gold in that currency. The currency value is expressed by inverting the number of units in the price and stating the value as a fractional portion of an ounce of gold.

An informative means of reviewing the value volatility of a particular currency is to graph the price of gold expressed in that currency or, better still, to graph the inverse of the price of gold as the value of the currency itself. For example, a graph of the price of gold in U. S. dollars from the beginning of the republic to August 15, 1971, would show a stable value of \$20.67/ounce from 1791 to 1934 (except during the "greenback" era of the Civil War and fluctuations during WWI as gold exports were suspended), when President Franklin D. Roosevelt devalued the dollar to \$35/ounce.

The \$35/ounce value remained until 1971, when President Richard M. Nixon signed an executive order closing the "gold window" of the Federal Reserve Board, meaning that gold would no longer be exchanged for dollars presented by European central banks. The price of gold increased to \$140/ounce by the end of 1972, and the President ended any tie between the value of the dollar and gold.

A graph of the dollar price of gold since 1971 to the present shows a period of great volatility as the dollar's value has been permitted to "float" to values determined by the market. Since the dollar had been the only currency in the world with its value tied to gold under the Bretton Woods protocol of 1944, no gold-based currency has existed since 1971.

Experience during these recent 33 years has been relative instability in all currencies, including the U.S. dollar, although the dollar remains to this date the primary currency used in international commerce. With the value of each national or regional currency depending upon

the administration of policies set by its own central bank, exchange rates among currencies have been highly volatile and difficult to predict.

International commerce and investment have been hampered, since transactions must protect against adverse effects of currency fluctuations or be exposed to substantial risks. Derivative securities designed to hedge against such risks have become cost factors in global funds flows. Currencies now trade on exchanges in volumes with greater value than similar trading in corporate equities and bonds.

Stabilizing Currency Value

This digression into the post-1971 experience of the international monetary system sets the stage for considering the means of stabilizing currency value according to classical monetary theory. *The primary and over-riding duty of the central bank responsible for managing the currency must be to achieve a stable value in the currency unit.* No other objective may be permitted to interfere with this duty. Otherwise, the stable value will be compromised and the currency will deteriorate.

Through most of modern history, central banks have demonstrated a commitment to maintain a currency's value by promising to exchange a stated amount of gold for each currency unit at the holder's option. The central bank's attention is thereby focused on maintaining the currency's value, since a depreciating currency will cause the bank to lose its gold reserves to parties who think the currency is losing value.

The premise has been advanced that such a gold-exchange mechanism is no longer feasible in the global economy because the amount of gold is insufficient and cannot match economic growth. The concern is entirely misplaced so long as the integrity of the currency is maintained.

No one prefers gold to currency when the currency is just as valuable as the gold and is expected to remain so. Currency, particularly one tied to the value of gold, is superior to gold in ease of ownership and use. Without

these important attractions, currency would not have been invented.

The gold-exchange mechanism assists the central bank in keeping currency value stable. On any particular day, if too many currency units have been issued (causing inflation), the holders of the excess units will bring them to the bank and exchange them for gold. If too few currency units have been issued (causing deflation), holders of gold will bring it to the bank and exchange the gold for currency to be used in commerce. In this manner, the gold-exchange mechanism achieves precisely the amount of currency demanded by the economy and, in so doing, keeps the currency's unit value stable.

So long as the currency value remains stable through use of this mechanism, very little gold changes hands at the margin. Gold reserves equal to the total value of currency issued are not required for efficient operation of the gold-based value stabilizing mechanism. The existing store of gold, far greater than any other commodity, is more than sufficient to serve as the measure of the currency unit value in this manner.

A central bank managing a currency without the gold-exchange mechanism has great difficulty finding an alternative signal that reliably shows when too many or too few currency units are being issued. Trailing indicators such as wages and prices are too laggard and too imprecise to be useful in guiding day-to-day central bank operations. Even prices of other commodities such as oil, metals or grains vary according to production and consumption demands to a much greater degree than does the price of gold. A central bank focusing on stable currency value will have difficulty achieving its objective without the gold-exchange mechanism, or at least a gold price target.

The selection of a target price of gold for a currency involves the concept of "equilibrium value" for the currency. Ideally, selection of the equilibrium value of a currency involves achieving the minimal need for further adjustment of prices consistent with maximum fairness to debtors and creditors of outstanding obligations. A reasonable approach to determining the equilibrium value is by computing the average gold price in the currency during the past 15 years. Equilibrium value for the U.S. dollar as

determined in this manner by Jude Wanniski of Polyconomics, Inc., is about \$350/ounce of gold.

A central bank may achieve a stable value for its currency by selecting a gold price target and then managing the currency with practices that achieve and maintain that target. For example, the U. S. Federal Reserve Board might adopt a target value for the dollar of \$350/ounce of gold. To achieve the target, the FOMC should manage the Fed's balance sheet by buying or selling government bonds.

If more dollar liquidity is needed, as shown by a gold price falling below the target, the FOMC should buy government bonds, thereby putting more dollars into the market. If too many dollars are in circulation, as shown by a gold price rising above the target, the FOMC should sell government bonds, thereby extracting dollars from the market.

When a central bank is assigned primary objectives other than currency value stability, the outcome can be economically destructive, depending upon the assigned objectives and how the central bank chooses to accomplish them. For example, the government empowering the central bank may legislate its purpose as price stability, job creation, economic growth or all of the above. If the central bank is sufficiently enlightened to use the gold-exchange mechanism, all these purposes can be achieved quite well through currency with stable value.

On the other hand, if a central bank is permitted or required to manage its currency by other means such as targeting particular interest rates or quantities of currency, its chances of success are greatly diminished. *An interest rate cannot be shown to have a directly proportional relationship to currency value.* An interest rate relates to the currency unit value only indirectly through all other variable factors as adjusted by the market.

Likewise, quantities of currency in the economy are not easily measured either accurately or timely. More importantly, a reliable guide to the quantity of currency needed by the economy from day-to-day has not been found as an alternative to the gold-exchange mechanism (or the gold price target). *The number of currency units demanded by the*

economy changes momentarily in relation to all factors affecting individual conduct. A central bank is incapable of adjusting money quantities on such a real-time basis.

A central bank cannot achieve stability of currency value by using a currency management tool such as an interest rate or a currency quantity. This is so because market forces prevent the central bank from selecting more than one target at a time. The central bank must devote resources to achieving the selected target, such as the interest rate or the money quantity. Then the market proceeds to adjust all other variables as consequences of the actions being taken by the central bank. One of the variables that is changed inevitably in this process is the value of the currency unit.

If a central bank has motives or purposes of its own, perhaps a hidden agenda, its currency management practices may be even more destructive. Such complications are not uncommon, because central banks have ties with traditional banks, the financial community, business, and national and international political interests.

The U.S. Federal Reserve Board, *e.g.*, is actually a private organization chartered under federal law. The Fed board is comprised of seven members, each nominated by the President and confirmed by the Senate. The Federal Open Market Committee has 12 members, including the seven Fed board members and five additional members selected from among the presidents of the 12 regional Federal Reserve banks.

Those who contend that a gold-exchange mechanism will not work in a global economy are likely reflecting a preference that the central bank be empowered to change currency value. The same may be said of a contention that an interest rate target is a preferable currency management tool in comparison to a gold price target or a gold-exchange mechanism.

In fact, a central bank with an independently managed, widely used currency can move from an interest rate target to a gold price target quite easily. The central bank simply chooses the gold price target (hopefully, near the equilibrium value point of outstanding private/public debt) and then manages its balance sheet (*i.e.*, buys or sells

government debt instruments to increase or decrease currency in circulation) to achieve the target gold price.

If the market price of gold on the spot market is below the target price, the central bank adds currency by buying government debt until the gold price rises to the target. If the market price of gold rises above the target price, the central bank removes currency by selling government debt instruments into the market. By managing its balance sheet in this manner, the central bank uses its open market trading desk as an alternative to the gold exchange window to add or remove currency liquidity.

The gold price target may be achieved without a public announcement by the central bank, but is likely to be achieved even more promptly with a public announcement. When gold price stability in the currency is demonstrated, adoption of a gold-exchange mechanism can proceed with minimal exposure to a rush by holders to exchange currency for gold.

Arguments are advanced occasionally that "floating" values for every currency are advantageous and reflect the proper functioning of free market forces. Advantages will not be found in floating currencies except among those who manage the currency, those who invest in currencies based on "special insights" into central bank intentions, or those with short-term political interests.

A very high price is paid by affected economies for unstable currency, and those who labor and own capital only in the form of currency pay the highest price. During currency deflation, the poor lose their jobs and must consume their saved capital. When currency inflates, the poor lose the value of capital they earned when its value was higher.

Analysis and Forecasting

Classical economics is an analytical and forecasting tool unmatched for reliability and accuracy. The principles discussed above form the pillars of the classical economic model.

Without the discipline of an analytical structure, the flow of data and information in the financial world becomes

an indecipherable torrent. Armed with classical economics, however, the investment professional sees influences of monetary and fiscal policy on markets with greater clarity and context. As each classical principle is understood in full context, it assumes a functional role in the analytical and forecasting process.

The foremost indicator of economic influences is the gold price signal of currency value and stability. In the current international monetary environment featuring no gold-price rule for any currency, not even the U.S. dollar, the gold price of each major currency fluctuates daily in spot markets around the world.³ Floating values of each currency make exchange rates between currencies complex and unpredictable. The only practical means of tracking currency value is by graphing the price of gold stated in the relevant currency.

Monetary practices of the U.S. Federal Reserve Board have produced severe swings in value of the dollar within the past eight years. First, the dollar's value rose between 1996 and 2001 from \$400/ounce of gold to \$250/ounce. Then the dollar's value fell during 2001 to 2004 from \$250/ounce to \$430/ounce.

As the pre-eminent factor in classical economic analysis and forecasting, the gold-price signal is first evaluated as to whether it is above or below the currency's equilibrium value. When the gold price is above equilibrium, the signal reflects some degree of inflation in the currency that (unless alleviated) will require upward adjustments in prices by the private economy over time. If the gold price is determined to be below the currency's equilibrium value, the signal indicates some degree of deflationary pressure from the currency.

Next the gold price signal is judged as to whether it is moving towards or away from equilibrium. If the gold price is rising farther from equilibrium, additional inflationary pressure is being added. If the gold price is falling back towards equilibrium, inflationary pressure is being reduced. If the gold price is presently below equilibrium, a rise in the gold price reduces deflationary pressure, while a falling gold price would increase

³ Kitco.com provides tracking and charting data on the price of gold and other precious and industrial metals.

deflation and require greater cuts in prices and wages over time.

The gold price signal is reliable and tells important stories to the public and to Fed governors, if they will only watch and understand. Regardless of the Fed's pronouncements, the gold price signal provides the best window to discover the actual effects of Fed policies and practices.

The gold price signal provides immediate readings regarding the prospects for inflation or deflation in the currency. Inflation and deflation have profound implications for businesses large and small, and for the equity and bond markets. Knowing that deflation is attacking profits (when the Fed and the financial media continue to assert inflation is rampant and being fought), e.g., is knowledge of great value to those who manage investment assets. This knowledge is available in real-time much sooner than the inflationary/deflationary pressures work themselves through the economy and the markets. In other words, *the gold price signal is a real-time indicator that enables asset managers to deploy assets in time to avoid losses and make gains.*

The use of fiscal influences in analysis and forecasting involves quantifying to a limited extent the effects of tax and spending actions of the government. Measuring the influences of cuts or increases in marginal tax rates on motivations and intentions to invest capital remains largely subjective. However, certain aspects of tax actions have direct effects on the availability of capital for investment.

If the corporate tax rate is reduced from 35% to 32%, the tax wedge is 8.57% smaller and the capital remaining for investment in equipment and talent is larger by 4.61%. When an individual's marginal tax rate is reduced from 38% to 35%, the tax wedge is reduced by 7.89% while the after-tax income rises by 4.84%. This is real capital to be deployed - not simply a mental or emotional incentive. Before the tax reduction, the individual may have a savings rate of 2% and the tax reduction may enable the savings rate to increase to 5% - an increase of 150% in the amount of capital for investment.

Such computations are useful in designing and evaluating tax laws, and in projecting the effects of such legislation on future economic growth. When tax rates applicable to labor or capital are in play, the effects do not begin and end with the date of tax refunds. Private capital accumulation will grow at a faster or slower rate for an extended period of time, depending on the tax law design.

Applying the principles of classical economics to the tasks of analysis and forecasting provides a more reliable and detailed picture of approaching economic and market conditions than is possible by any other means. When you know the extent of inflation or deflation present, and the extent of obstacles or benefits presented by tax laws, you are better armed than many participants in the market. These insights may be extended into evaluation of prospects for economic growth and of specific business sectors. Fully implemented, classical economics is the most valuable tool available to explain and forecast the effects of monetary and fiscal policy.
