



The Rennie Quarterly Return

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The “Wedge Model”

The dismal science of Economics is resplendent with an almost unlimited supply of conceptual, statistical, esoteric, and avant-garde terms designed to educate those trying to understand how economies and markets work. Unfortunately, concepts like mean-variance optimization, Fibonacci numbers, the Capital Asset Pricing Model, and the Multi-Factor Risk Model do little for those who spend their full time building widgets to earn a living.

Included in this plethora of terms is the Wedge Model developed by Economist Arthur B. Laffer in the mid-70s. We first read about it in The Way The World Works, a seminal work by Jude Wanninski. Laffer’s testament to the book is shown on the back cover: “In all honesty, I believe that it is the best book on economics ever written.”

The Wedge Model explains how government intervention, mostly in the form of taxes and regulation, can be a dominant force in the efficient operation of an economy.

Way back when

Let’s go back in time to when mother Earth was sparsely populated. There were no cities. Humans lived in small groups known as clans. All basic needs were met within the clan. Each clan had farmers, hunters, clothing and shoe makers. When one needed shoes for example, one would get them from the clan shoe maker and provide a service or product of their own in payment, i.e., a classic barter (or private) economy.

Inevitably the clans grew and it became obvious that some overall clan leadership would enhance the goods-services-bartering process. Initially, some clanspeople probably volunteered some of their time to take on these leadership responsibilities. When the responsibilities became full-time, the leaders then required resources from the clan to meet their own personal obligations; they had no products of their own to barter. The idea of a tax was born. Thus the barter economy transitioned to the money (or public) economy where all transactions were in full view of the leadership (government) and taxed. The clanspeople still worked just as hard but saw their income reduced to the extent of the tax. Effectively a wedge had been inserted into their flow of income.

Fast forward

Certainly, everything has gotten bigger and far more complex to be sure. Governments have become enormous with almost unlimited powers. Tax authorities and strategies are legion: federal, state, local sales, inheritance, value-added, all wedges to be sure.

Tomes of regulations continue to be approved covering what can be built, where, when, how, and how it should be maintained and even eventually demolished, all requiring complex documentation and government inspection. Financial and medical regulations are even more challenging. Regulations are wedges pure and simple.

Even things like subsidies and tariffs are wedges. They cause inefficient behaviors which would not be seen in a truly efficient marketplace.

It should be obvious. As taxes are raised, regulations published or subsidies and tariffs imposed, the size of the wedges get larger—and markets become more inefficient, less productive.

Consider the plight of the artisans of today. To go into business, they must first file multiple levels of applications to several authorities. They’ll probably have to hire attorneys to help them through the initial process and ongoing legal requirements. They’ll have to prove their skills before some kind of board of experts. And they’ll need accounting assistance to be sure. While we tend to accept these things as merely the cost of doing business, their effect on the efficient operation of markets gains focus when compared to non-requirements of a barter economy.

The Wedge Model is indeed a very simple yet powerful concept. It easily allows one to assess the true, uncomplicated effect of very complex issues.

So, the next time you hear about new tax proposals, regulations, subsidies and/or tariffs, consider whether they will make the wedge larger or smaller, i.e., decrease economic activity or increase it.

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Please note that Rennie & Associates 2013 Brochure, filed with the CA Dept. of Corporations, is available on our website.

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Our Two



Jobs are the product of a growing economy.

Jack Welch
Ex-CEO, General Electric Corp.



Quarterly Trivia:

How much of each dollar spent by the U.S. Government so far in fiscal 2013 has been borrowed.

Congressional Budget Office
46 cents