The Big Boom

By Bret Swanson | September 13, 2007

In 2007, U.S. GDP will approach $14 trillion, tax revenue will easily top $2.5 trillion, and the budget deficit will drop towards a trivial 1% of GDP. Despite recent volatility, domestic stock markets remain near all-time highs achieved earlier this summer. Riding a worldwide surge of tax cuts, free trade, and innovation, global output this year will surpass $50 trillion. But in reading Jonathan Chait's new book *The Big Con*, one would assume that the Reagan and Bush economic programs had plunged the U.S. into depression and the global boom did not exist.

One would have to assume. Because in this book about "crackpot economics," Chait has remarkably little to say about economic growth, tax receipts, budgets, or the epochal story of globalization. With all the global evidence refuting Chait's predetermined conclusion that supply-side economics doesn't work, he retreats to a political analysis of the Republican Party and petty defamation of some of the era's most important economic thinkers.

Chait's thesis is that the Republican Party has been captured, and the U.S. therefore governed, by the supply-siders, a small economic "cult" of "off the wall," "insane," "totally deranged, completely nuts," "sheer loons." He begins with the assertion that supply-side economics has been "conclusively disproven" and moves on to ridicule the excesses of K Street lobbyists. Chait's exposé of K Street bloat is undeniable and humorous, but he seems not to realize that the K Street explosion utterly contradicts his central charge against supply-side economics.

After 25 years in which supply-side tax cuts dominated U.S. economic policy, how is it possible to pay for K Street's preposterous pork, perks, and narrow tax preferences, not to mention Iraq, Afghanistan, and entitlements, all with a miniscule deficit? If supply-side tax cuts didn't positively affect economic growth and thus tax receipts, how could federal tax revenue, at nearly 19% of GDP, possibly be higher today than the 18.2% average of the last 40 years?

Economist Alan Reynolds has highlighted this remarkable tendency for Federal revenues to hover around 18% of GDP (and for personal income tax revenue to gather between 7.5 and 9% of GDP), *no matter if tax rates are high or low*. Call it Reynolds' Law. Low tax rates that yield 18% of a larger, faster growing economy are better than high tax rates yielding 18% of a smaller economy. Conservatives might well strive to reduce this tax-to-GDP ratio, but the supply-side cuts to date have been so powerful that such an objective will require *far more aggressive tax cuts and tax reform*. Steve Forbes has shown that under some variant of a flat tax, we could reduce this tax-to-GDP ratio over the long run but still collect absolute tax revenues that exceed existing projections.

Chait can't address these strategic questions because he doesn't grasp the central concepts or history of the supply-side. In the 1960s and 70s, Professor Robert Mundell built the foundation of supply-side economics with a mix of new ideas and old. Mundell foresaw the coming era of globalization and developed a new international model where capital (and to some degree labor) moved around the globe. Instead of pretending that nations could isolate themselves and conduct purely domestic policy unaffected by others, Mundell knew the world was becoming flat. "There is," Mundell said, "only one closed economy—the global economy."

The second component of supply-side economics harkened back to Jean-Baptiste Say, the early French economist who showed that "supply creates its own demand." It's the creative, productive, "supply" side of the economy—the worker, investor, technologist, entrepreneur—that drives economic growth. Economic policy must therefore be judged by its impact on the microeconomic incentives and decisions of firms, households, and innovators. Instead of the prevailing Keynesian view in which macro aggregates could be manipulated to affect the demands of individual citizens or corporations, the supply-siders thought it was the crucial microeconomic decisions of work, investment, risk-taking, and discovery that summed up to yield the aggregates.

These foundations—Globalization and Say's Law—led the supply-siders in the 1970s to a series of policy proposals on money, taxes, trade, and regulation. Mundell had already developed both his monetary approach to the balance of payments and the theory of optimum currency areas, which 30 years later would be put into practical effect as the successful euro currency. He would go on to win the Nobel prize for these innovations in 1999. But the problem in the 70s was stagflation—simultaneous inflation and stagnation—and the entire economics establishment was baffled. Only the supply-siders had an answer.

If workers and investors drove the economy, if they responded to incentives (and disincentives), and if capital and labor were shifting faster in a more open and competitive world, then tax rates and stable money mattered more than ever. Diagnosing the high-tax, loose-money disease, Mundell, with his University of Chicago colleague Arthur Laffer, began arguing for a return to stable money and substantial tax cuts. The establishment, which didn't believe taxes had much to do with growth nor that money was central to inflation, argued first, that tax cuts would flood the economy with dollars and exacerbate inflation; and second, that printing less money would cause contraction. In fact, just the opposite happened. Persuaded by Mundell, Laffer, and Rep. Jack Kemp, Reagan's tax cuts both spurred growth and soaked up excess money, thus reducing inflation. Fed chairman Paul Volcker's tighter monetary policy stabilized the dollar and gave entrepreneurs and investors a stable platform from which to launch new enterprises. The American and global booms began.

Almost 30 years later Chait offers only a crude caricature of these historic ideas and events. He says supply-side economics is the narrow and "monomaniacal" belief in "tax rates as the single driver of all economic change" and that all tax cuts always yield higher revenues immediately. But supply-siders are at least as concerned with monetary policy, they obsess over free trade and regulation, and their views on the dynamics of taxation are of course far more sophisticated than Chait's poorly-drawn cartoon.

In his 1990 book *The Growth Experiment*, Harvard economist Lawrence Lindsey very carefully endorsed supply-side economics and showed substantial revenue reflows from both supply- and demand-side effects in the 1980s. He also exposed the substantial dead-weight losses, or utter waste, that high marginal rates can inflict. Laffer, whose

Curve proved an undeniable and effective heuristic tool, was always careful to note that the revenue effects of tax rate changes depend crucially on the nature of the tax and the time period observed. Nevertheless, in a big, flexible economy that can cover any short-term revenue shortfalls with debt, well-designed tax cuts and tax reforms were long-term investments that would yield large—although not completely knowable—returns in both growth and revenues.

Long skeptical, establishment economists now mostly embrace the supply-side view of taxes, growth, and revenue. Nobel prize winner Ed Prescott has done voluminous work comparing the U.S. and the relatively high-tax economies of Western Europe and found that high taxes significantly depress European labor and output, leading to persistent deficits. In the summer of 2007, Christina and David Romer of Berkeley released two papers showing that "tax increases appear to have a very large, sustained, and highly significant negative impact on output," "tax cuts have very large and persistent positive output effects," and tax cuts do "not have any clear impact on revenues at horizons beyond about two years." If we can collect the same amount of revenue over the long-term with consistently higher growth rates, who can object to lower tax rates?

Any set of policies will have enthusiastic cheerleaders who may overstate, botch, or contaminate the pure intellectual source. When President Bush famously sold his 2003 tax cuts in purely demand-side terms, Larry Kudlow would each night on CNBC praise the policy but shake his head at the bungled explanation. The supply-side economists are not responsible for every misstatement of every supportive politician or TV talking head, but even these lay supply-side sympathizers have turned out more right than their critics. It now looks as if the supply-side economists, who did predict higher growth and major revenue effects but did not predict every tax cut would "pay for itself" in the short term, were if anything too cautious. "The supply-side economists…" concluded Nobel laureate Robert Lucas, "have delivered the largest genuinely free lunch I have seen in 25 years in this business, and I believe we would have a better society if we followed their advice."

Although supply-side policies have substantially boosted the flows of GDP and tax revenues, their effects on American wealth have been even more dramatic. On this point, John Rutledge, a Reagan advisor who developed a new asset shift concept of taxes and interest rates, was prescient. In 1981, when the supply-side policy experiments began, the stock of U.S. tangible and financial assets was around $14 trillion. Today U.S. assets exceed $100 trillion, and could be closer to $150 trillion. As nominal U.S. GDP expanded four-fold in the last 25 years, from $3 trillion to $13 trillion, nominal U.S. assets have expanded more than seven-fold, and maybe as much as ten-fold.

The global supply-side story is even more astounding. From Ireland to Eastern Europe to China, the supply-side concepts of stable money, low tax rates, and free trade have powered an unprecedented global boom that has brought hundreds of millions of people out of poverty and into the modern world. China and Russia, the Communist titans of last century, are now low-tax capitalist juggernauts. India, for 50 years a sad story of stagnant socialism, is furiously, and fortuitously, playing catch up. The ripple effects of the supply-side revolution—which have made the U.S. and world economies more flexible, more open, more free—cannot be overstated.

Yet despite numerous Nobel endorsements, Chait says that supply-side economics has "no academic foundation." But as with taxes, the academy has now adopted other supply-side innovations. In the late 70s and early 80s, for example, George Gilder explained the central importance of the creative and dynamic entrepreneur operating in an arena of uncertainty. He said technology was not coincident to economic growth but was its chief engine. Observing the knowledge economy of Silicon Valley, he said economics was not just about scarcity but abundance. Speaking of entrepreneurship and technology to the *New York Times* in 1980, Gilder insisted, "It's what economic growth is all about."

A decade later the brilliant Stanford economist Paul Romer formalized these ideas and delivered his seminal work on "Endogenous Technological Change," which brought the increasing returns of technology to the center of the model and spawned a whole research field in "New Growth Theory."

The consensus economic models have long lacked a way to incorporate dynamism and entrepreneurship. But just last month, the 2006 Nobel winner Edmund Phelps told the *Financial Times*:

> "I am having a lot of fun thinking about capitalism and trying to imagine how economics would have to be re-written to capture the heart of that kind of system." Traditional economics, he explains, sees the world as if it were a plumbing system. "It's basically rooted in equilibrium—things work out as people expect them to do." Capitalist reality, however, "is a system of disorder. Entrepreneurs have only the murkiest picture of the future in which they are making their bets, and also there is ambiguity, they don't know when they push this lever or that lever that the outcome is going to be what they think it is going to be—there is the law of unanticipated consequences. This is not in the economic text books, and my mission, late in my career, is to get it into the text books."

Half a century before the supply-siders, legends like Frank Knight and Joseph Schumpeter had emphasized innovation, downplayed scarcity, and presaged the idea of increasing returns. But defying intense criticism from the Keynesian demand-side establishment, it was the supply-siders who revived and extended many of these ideas. It took a long time, but again Gilder and the supply-siders were proved right. In a stunning admission just a few months ago, the eminent establishment economist Robert Solow wrote that now "Schumpeter outshines Keynes."

The supply-siders also rejected the Phillips Curve, the idea of a devil's trade-off between inflation and unemployment. It's what allowed them to confidently propose the original Mundell-Laffer policy mix of tight money and large tax cuts, which yielded both lower inflation and lower unemployment. Again, all these years later the academy is catching up with the supply-siders. Last year Phelps won his Nobel for work he did in the late 60s refuting major foundations of the Phillips Curve. And although Ben Bernanke's Fed staff still uses a quasi-Phillips model, in a speech just this summer Bernanke put another academic nail in Phillips' coffin. In the battle of famous curves, Laffer has won decisively.

Chait criticizes the supply-siders for being eccentric and uncredentialed. Some of them were. In any field, academic discipline can be a crucial guardrail preventing mistakes, but it can also block important new ideas. As the Financial Times recounts, "Phelps"—only now, with Nobel Prize in hand—"feels that he is at the stage in his career 'where I can afford to be as radical as I want to be.'" It was precisely Jude Wanniski's eccentricity and lack of academic constraints that freed him to recognize the deep but unconventional insights of Mundell and Laffer. It was only his zealous persistence that persuaded the intellectual and political minds that mattered. Quarterback Jack Kemp didn't know more textbook economics than the Keynesian technocrats, but he saw through the academic clutter of the day. He picked up the Mundell-Laffer ideas and ran with them, persuading Ronald Reagan and a majority of Congress to follow.

A new generation of supply-side business economists has proved the most prescient on Wall Street. David Malpass, Don Luskin, Brian Wesbury, and Michael Darda now serve up the most incisive—and profitable—analyses. But far from being "monomaniacal" or marching in lock-step, supply-siders have for the last decade engaged in spirited debate over monetary policy. The most interesting Wall Street and monetary debates these days are happening within the loose arena of supply-siders, often on Larry Kudlow's nightly CNBC show, which entertains by far the most sophisticated economic discussions found anywhere on television.

Far from being "insane," "deranged," or merely "radical," economist Bruce Bartlett who was present at the creation believes "supply-side" economics has become so conventional that we should retire the term. "Today," Bartlett writes, "hardly any economist believes what the Keynesians believed in the 1970s and most accept the basic ideas of supply-side economics—that incentives matter, that high tax rates are bad for growth, and that inflation is fundamentally a monetary phenomenon. Consequently, there is no longer any meaningful difference between supply-side economics and mainstream economics."

Unable to fight on theoretical or empirical grounds, Chait deploys vicious rhetoric to scare the GOP away from the economically and politically successful supply-side strategy. Chait has great reverence and nostalgia for those economic titans Herbert Hoover, Richard Nixon, Gerald Ford, and Bob Dole. Chait advises the GOP to remake the party in their image. But let us review: Hoover, who sparked the Great Depression with massive tariff and tax hikes, lost in 1932; Nixon, who imposed wage and price controls, endless new regulations, and set off a decade of inflation by floating the dollar, resigned in 1974; Ford, a decent man with no solution to stagflation, lost in 1976; and Dole, the Beltway compromiser who never grasped or believed in the supply-side program, lost in 1996. The big con, indeed.

In analyzing supply-side economics, Chait would have done much better writing about The Big Boom.

Bret Swanson is a senior fellow at the Discovery Institute.