The Timeless Principles of American Prosperity

By Peter Ferrara, 7/28/10

We know, based on economic experience, theory, and logic, how to create another economic boom that will last 25 years, or a generation into the future. We achieved that in America from the end of 1982 to the end of 2007, with only two, short, shallow recessions that barely interrupted sustained, robust, economic growth. But that was not the only instance of success. Several times in the last 100 years, whenever the nation's economic policies adhered to the timeless principles of economic growth and prosperity, our economy has boomed. When it has departed from those policies, it has fallen into stagnation, or worse.

Moreover, as we will discuss next week, such booming economic growth is much more beneficial for working people and the poor than counterproductive, socialist redistribution to achieve equality of results. A booming market economy produces a much higher standard of living for working people and the poor. This is especially so when policies are structured to channel the flows of booming economic growth through working people and the poor, as we will explain. Economic experience, theory, and logic shows that outdated, throwback, socialist redistribution, by contrast, inevitably leads to lower standards of living, stagnation and decline.

America today once again desperately needs to return to the timeless principles of economic growth, to restore our traditional, world leading prosperity, and the American Dream. This should be the central argument and theme for this fall's elections.

A Hundred Years of Supply-Side Economics

Last year, the Intercollegiate Studies Institute produced a brilliant, overlooked book that recounted the history of supply-side economics -- *Econoclasts: The Rebels Who Sparked the Supply-Side Revolution and Restored American Prosperity*, by Brian Domitrovic. As explained in that book, the roots of supply-side economics go back to 1913, when the national income tax and the Fed were first adopted. "For restraining the institutions created that year -- the income tax and the Federal Reserve -- is the essence of supply-side thinking," Domitrovic writes.

It didn't take long for trouble to brew. The top tax rate of 7% soared to 77% by 1918. Moreover, the income tax, sold as a tax on the rich, began to apply at just $1,000 in income (equivalent to about $20,000 today). In addition, during World War I, the Fed essentially doubled the money supply relative to the economy. Inflation consequently soared by 84% over the 4 years from 1916 to 1919. The Fed then slammed on the brakes, draining 60% of the excess money, and throwing the economy into steep recession as a result. Unemployment soared to 12%, 50% higher than in any previous recession.

Warren Harding, newly elected President in 1920, appointed the enormously successful Pittsburgh banker Andrew Mellon Secretary of the Treasury, with the duty of fixing the economy. Mellon adopted what became the supply-side economic formula. He slashed the top income tax rate to 25%, and the bottom rate from 8% to 1%, increasing the income level to which it first applied by 50%. Moreover, Mellon led the Fed to stop the money supply drain, return interest rates to standard levels, and devote itself to stable prices. The Fed would look to market price levels, particularly commodities, including gold, for its guide.

The result was the Roaring '20s, the greatest boom in American history to that point, essentially beginning the modern American economy. Real output galloped, stock prices tripled, real wages advanced with productivity increases, and prices were stable. "It was in the twenties that Americans bought their first car, their first radio, made their first long distance telephone call, took their first vacation," as Domitrovic quotes Richard Vedder and Lowell Galloway.

Domitrovic explains, "The essence of supply-side economics lies in using the two levers of governmental economic leverage for the specific uses at which they are most adept. Monetary policy is capable of maintaining the price level. Tax policy is capable of spurring growth. The 'policy mix' of stable money plus tax cuts is the secret to escaping stagflation."

Tax policy spurs growth by reducing tax rates, as Mellon did. The lower rates spur incentives for productive activity, like savings, investment, work, business creation and expansion, and job creation, by allowing the productive to keep a higher proportion of what they produce. These incentives, moreover, apply to every economic decision with every dollar in the economy, at home and around the world in regard to the American economy, not just to the amount of any tax cut. Supposed tax cuts involving credits or rebates are just giveaways like welfare and other government spending, without the powerful incentive effects of rate cuts.

Monetary policy controls the price level because inflation is too many dollars chasing too few goods, everywhere and always caused by printing up too much money in relation to the demand for money. The one and only solution to inflation is to restrain money supply growth to equal money demand. Maintaining stable prices means also avoiding deflation by maintaining money growth to keep pace with money demand. The Fed should follow this policy by monitoring market prices, particularly the most sensitive prices such as commodities, including gold.

Monetary policy cannot be used to stimulate the economy because in the long run it just washes out in affecting only the overall price level, and not the level of real output. In the short run, trying to control the economy by monetary policy just adds to instability, sometimes grievously, causing booms and busts, bubbles and crashes. Keynesian economics is even more inept, because economic prosperity is not caused by increasing government spending and deficits, which are at best a wash, and more likely a drag, as the private sector would use the resources more productively and efficiently than central-planning government bureaucracies lacking market incentives for guidance.

These are the timeless principles of economic growth and prosperity.

Going Off the Rails: The Depression Keynesian Blunder

The Depression arose and worsened as America departed from these pro-growth policies. Instead of maintaining stable prices, the Fed allowed the money supply to decline precipitously, even while dollar demand was soaring as the world sought a stable store of value. This created ruinous deflation. Mellon's tax rate policies were also ruinously reversed, with the top income tax rate raised first to 63%, and then to 79%, with the lower tax rates raised even more in percentage terms. The Smoot-Hawley tariff added another tax burden that killed international trade. President Roosevelt tried to restore prosperity with soaring Keynesian government spending and deficits, which failed miserably as the Depression dragged on for over 10 years. By 1933, unemployment was at 25%, and GDP was down 57% nominally, 22% in real terms.

The Bretton Woods global monetary regime agreed to in 1944 essentially took Mellon's monetary policy focus on stable prices worldwide. The dollar was convertible to gold at $35, and all other currencies were convertible to the dollar at fixed exchange rates. As long as that was maintained, prices would be stable, as they were until overly expansive U.S. monetary policy caused the system to break down completely in 1971. Bretton Woods also essentially nullified Keynesian stimulus policies, as sustained high deficits for any country were inconsistent with the fixed exchange rates and dollar gold convertibility.

This price stability augured a 25-year, postwar, worldwide economic boom. Domitrovic writes, "There can be no mistake that in the high years of the Bretton Woods system, roughly 1950-70, the world economy established incredible feats. European and Japanese growth was sustained at a nearly 7% rate, and the United States (which had started at a higher basis) enjoyed long booms over 4%." Supply-side, free market, policies produced in particular the postwar German "economic miracle."

Kennedy's Supply-Side Economics

But with recessions in 1953, 1957, and 1960, a true economic boom was not restored in America until the Kennedy tax cuts of the 1960s. Kennedy was surrounded by Keynesians who were willing to support some tax cuts focused on stimulating demand. But President Kennedy himself had a supply-side understanding focused on tax rates, saying, "It is a paradoxical truth that tax rates are too high today, and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the tax rates…. [A]n economy constrained by high tax rates will never produce enough revenue to balance the budget, just as it will never create enough jobs or enough profits."

Domitrovic explains that in 1958 a young Robert Mundell, destined to win the Nobel Prize in 1999, first began to explicitly advocate the supply-side policy mix, first from his perch at the IMF, then as a Professor of Economics at the University of Chicago. Domitrovic quotes Mundell as explaining that President Kennedy overruled his Keynesian advisors and "reversed the policy mix to that of tax cuts to spur growth in combination with tight money to protect the balance of payments," the exact supply-side agenda Mundell had been advocating, though Mundell disclaims having influenced Kennedy directly. Mundell continues, "The result was the longest expansion ever [up to that time] in the history of the U.S. economy, unmatched until the Reagan expansion of the 1980s."

Kennedy's business tax cuts were adopted in 1962, and the personal rate cuts in 1964. The top income tax rate was slashed from 91% to 70%, with the lower rates reduced by similar proportions across the board. The next year, economic growth soared by 50%, and income tax revenues increased by 41%! By 1966, unemployment had fallen to its lowest peacetime level in almost 40 years. *U.S. News and World Report* exclaimed, "The unusual budget spectacle of sharply rising revenues following the biggest tax cut in history is beginning to astonish even those who pushed hardest for tax cuts in the first place." Arthur Okun, the administration's chief economic advisor, estimated that the tax cuts expanded the economy in just two years by 10% above where it would have been.

The 1970s: Return to Keynesian Fallacies

The postwar boom ended as the liberal Johnson Administration abandoned the hugely successful supply-side policy mix. Federal spending started to soar in 1965, and President Johnson demanded and got a loose monetary policy focused on supposedly maintaining growth rather than stable prices. The tax increases started in 1968 with the 10% income tax surcharge, the alternative minimum tax, and increased capital gains levies, followed by bracket creep once inflation kicked in.

By 1969, 6.2% inflation resulted, along with the 1969-70 recession, and the economic miracle of stagflation had arrived, supposedly impossible under the doctrine of Keynesian economics. For the rest of the decade, Keynesian monetary policy kept trying to boost the economy out of decline, only to have to reverse course when inflation soared, causing the economy to fall into recession again. This resulted in further recessions in 1973-75, 1980, and 1981-82.

It finally came to an end when President Reagan explicitly abandoned Keynesian economics, and openly embraced the supply-side. He adopted 25% across the board income tax rate cuts, and then tax reform in 1986 that reduced the top rate from 70% in 1981 to 28%, with only one other rate of 15%. He bravely endorsed tight money through the teeth of the recession to stop inflation, which worked spectacularly. While prices rose 25% in just two years from 1979-80, annual inflation collapsed by half to 6.2% by 1982, and half again to 3.2% by 1983.

Reagan added deregulation to the policy mix, which reduced the cost burden on production, further stimulating it. The Reaganomics formula also included domestic spending cuts, which even with the defense buildup that won the Cold War without firing a shot, reduced total federal spending as a percent of GDP by 10% by 1989.

The results were so spectacular they astonished and surprised everyone, from opponents who wouldn't admit it, to the architects of Reaganomics themselves. Besides slaying inflation which most thought by then couldn't be done without destroying the economy, by the end of 1982 the economy took off on the above mentioned, 25-year economic boom, what Reaganomics gurus Art Laffer and Steve Moore have rightly called "the greatest period of wealth creation in the history of the planet." These results have been recounted in this column several times in the past, and the complete story is too long to do it further justice here.

The Bush/Obama Great Recession

What needs to be recounted at this point is that the Great Reagan Boom ended when, again, the supply-side policy mix was abandoned. Soon after Bush was elected, the Fed returned to using monetary policy to stimulate and manage the economy rather than focusing on price stability. The loose monetary policy from 2001 to 2006 even kept real interest rates below zero for 2½ years during that period, which effectively subsidized excessive risk and leveraging. The result was the housing bubble, which created the financial crisis when it popped in 2008.

Equally promoting the bubble was the Clinton Administration/liberal Democrat "affordable housing" policies, creating the subprime mortgage market. Fannie Mae and Freddie Mac were dragooned to finance the bubble to its eventual scary dimensions. Reregulation forced banks to contribute more financing to subprime mortgages and the housing bubble as well, and further contributed to the crisis with mandatory mark to market accounting, and privileged status for the credit rating agencies that rated subprime mortgage backed securities AAA.

Spending also began to race out of control during those Bush years. Finally, when the crisis hit, instead of resorting to the supply-side tool of reducing tax rates to promote growth, the Bush Administration peculiarly reached back to the 1970s with a Keynesian government spending, tax rebate package in February 2008. Every one of the planks of Reaganomics had been abandoned at that point.

Barack Obama had personally supported every one of these steps leading to the financial crisis, going back to the Clinton era. Once elected President, he simply reupped every one of these disastrous policies multiple times. He led enactment in February 2009 of basically the same Bush/Keynesian stimulus of a year prior, only 6 times as large. He exploded government spending and deficits to record shattering levels. He embraced re-regulation with a vengeance. And starting next year he has scheduled sharp increases in every significant federal tax rate.

Following with such devotion the opposite of every plank of Reaganomics, we can only expect exactly the opposite results, as Art Laffer has so rightly predicted. The economic history of the 20th century as recounted above backs him up quite thoroughly.

Next week we will discuss in full detail how to avert this disaster, and restore for all traditional American prosperity and the American Dream that has drawn hundreds of millions to these shores over the last 400 years.

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