# RECESSIONS AND RECOVERIES

## *Lessons Not Learned*

Tom Kelly

CENTER OF THE AMERICAN EXPERIMENT

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### Foreword

Too bad we've had to suffer through an atrocious economic mess as a prerequisite, but *Recessions and Recoveries: Lessons Not Learned*, by Tom Kelly, is one of the best things you'll read about the potency and recuperative powers of free markets.

An American Experiment Senior Fellow, Mr. Kelly notes how we're three years into a financial crisis ignited by the bursting of the housing bubble and more than two years into a resulting recession and aftermath that just hangs in. "It was the deepest recession we experienced in a generation," he writes, "by some measures, the deepest since the Great Depression of the 1930s. In terms of economic policy, however, we have regressed to the early 1970s, before the last 'great recession' of 1974-82, when Richard Nixon infamously said, 'We are all Keynesians now.'"

Nevertheless, Tom argues, current economic debates still somehow persist in being "dominated by ideas that were tried and found wanting" decades ago. Why? "One answer," he continues, is that "the country seems to have forgotten that a small cadre of economists and politicians accurately diagnosed the cause of the malaise of the 1970s as the prevalent economic thinking of the time," and that during the '80s, they set the nation "on a different course," leading to a quarter-century of virtually uninterrupted growth.

Which is to say, as his Introduction concludes, it's time for "a journey down memory lane." What happened during the 1970s, and why? What changed during the 1980s, and why does it still matter? What lessons should have been learned? If, in fact, learned at some point, why have they been forgotten? And most immediately, how can we implement those lessons "in the context of today's economic crisis?"

What, you ask, might those lessons precisely be? At the risk of a little too much condensing, they're captured in the paper's opening epigram by a scholar named Mario Rizzo: "The great debate is still Keynes versus Hayek. All else is footnote."

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Chicago Law School and a former clerk for a federal appeals judge, he did his undergraduate work at Union College, finishing (as the following pages frequently suggest) summa cum laude in history.

My great thanks to Tom for this first-rate and exceedingly timely piece of analysis. And as with everything we publish and do, I very much welcome your comments.

**Mitch Pearlstein, Ph.D.**
***Founder & President***

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*Mario Rizzo*
*New York University*

## Introduction

We are now three years into the financial crisis triggered by the bursting of the housing bubble, and more than two years into the resulting recession and lingering aftermath. It was the deepest recession we experienced in a generation—by some measures, the deepest since the Great Depression of the 1930s. In terms of economic policy, however, we have regressed to the early 1970s, before the last "great recession" of 1974-82, when Richard Nixon infamously said "we are all Keynesians now." Today's policy debate has been dominated by ideas that were tried, and found wanting, during the 1970s. The policy responses to date have consisted of two sets of actions. One is increased federal spending and "targeted" tax breaks, based on the theory of a "multiplier" effect that will result in each dollar spent and each dollar of tax relief being respent several times. The second is unnaturally low interest rates. This combination of policies failed to generate economic growth a generation ago but is being tried again on a far grander scale today.

Why has this happened? In part the answer is political. Keynesians give politicians advice they want to hear: that they can and should do things, for which they can take credit, to benefit their constituents. Democrats, who always want to expand the role of the state in the economy, always favored Keynesian theory. But that isn't the whole story. Our current policy response began in 2008

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under the previous, Republican administration. Monetary policy has been directed by Republican appointees to the Federal Reserve Board, most notably Chairman Ben Bernanke. For the most part, Republican leaders in Congress and conservative pundits have not offered serious alternatives to the policies being pursued by the Obama administration. Some conservatives, including Bruce Bartlett and Richard Posner, have gone as far as to support these policies as the appropriate response to a steep recession. Even where alternative policies have been formulated and forcefully advocated, most notably by Rep. Paul Ryan of Wisconsin, there has not been an effective effort to explain why and how alternative policies will bring an end to our current economic downturn, while Keynesian policies will not. The country seems to have forgotten that a small cadre of economists and politicians accurately diagnosed the cause of the malaise of the 1970s as the prevalent economic thinking of the time and during the 1980s set the

country on a different course that led to a quarter-century of nearly uninterrupted economic growth.

So it's time for a journey down memory lane. What happened in the 1970s, and why? What changed in the 1980s, and why did it matter? What were the lessons we should have learned from the economic malaise and subsequent recovery a generation ago? Why has the country and its leadership not learned, or forgotten, the lessons of that time? And what should we do to implement those lessons in the context of today's economic crisis?

## I Remember When Rock Was Young

I took my first college macroeconomics course as a freshman in the fall of 1976. While I was taking that course, Jimmy Carter was elected president. The textbook was Paul Samuelson's *Economics*, and the lessons were Keynesian. Managing aggregate demand was the objective of policy, to minimize unemployment up to the point where it led to inflation. Whether that demand consisted of paying people to dig ditches and fill them again or productive investment made little difference. Demand could be managed either through spending or taxes, although spending was the more effective tool, because it had a higher "multiplier" and thus produced more economic growth. There was a tradeoff between inflation and unemployment, the so-called Phillips Curve, that policy had to manage.

By the time I took this course, much of what was included in the textbook was known to be wrong or strongly suspected to be wrong. Milton Friedman and Edmund Phelps had already written their seminal papers demonstrating that the Phillips Curve was an illusion. Friedman had already won his Nobel Prize, in part for that work (Phelps's Nobel didn't come until 2006). Friedman's monetary explanation for the "Great Contraction" of 1929-33 was becoming the standard wisdom, and it was well understood that New Deal spending had not ended the Great Depression (although the prevailing view was that much greater World War II spending had done the trick). None of this had yet penetrated into freshman macroeconomics, but the intellectual groundwork for the repudiation of Keynesian economics was in place.

Over the course of my four years in college, the Keynesian edifice was discredited by the "stagflation" that characterized those years. At the end of 1976, unemployment was 7.8 percent and falling, and inflation (measured by CPI) was 4.9 percent. By December 1979, unemployment was 6 percent and rising, while inflation had soared to 13.3 percent. No Phillips Curve in sight. Carter and the Democratic Congress increased spending by more than 17 percent (adjusted for inflation) over the four years I attended college, but the country was experiencing economic malaise. By my senior year, Keynesian hegemony in the academy was being replaced by a "post-Keynesian neo-classical synthesis" that recognized the limited ability of demand management policies to influence economic performance over time.

But the real revolution was taking place elsewhere. A small but growing cadre of economists was arguing that economic growth was not a matter of managing demand but of increasing supply. In other words, improving the productive capacity of the economy was the key to growth. Policies that were viewed as neutral or even beneficial from a Keynesian perspective were, in fact, counterproductive from a "supply-side" perspective. Keynesian economics doesn't tell politicians what they should spend money on, but it does tell them that their spending helps the economy. What politicians spend on, of course, is projects, regardless of economic merit, that benefit their constituents and the interest groups that support them. And there is no reason to believe that this spending will increase the productive capacity of the economy.

By the late 1970s, new policies that recognized this problem were coming into vogue. Reduced marginal tax rates were first adopted, primarily on Keynesian grounds, during the Kennedy administration, and capital gains tax rates were cut during the Carter administration. The push for deregulation in some industries began under Presidents Ford and Carter.

But it was Ronald Reagan's administration that adopted a supply side view of the economy and made it the basis of its economic policies.

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In the three decades since 1980, however, the term "supply side economics" has become linked in the public mind with a single idea: that cutting taxes will increase government revenue. Google "supply side economics" if you don't believe me. But the heart of supply side economics was never the Laffer curve. It was always an understanding of how economic growth happens and how Keynesian economic orthodoxy led to policies that undermine growth. That understanding explains why the '70s stagflated, why the '80s and '90s boomed, and why today's recovery from the steep recession of 2008-09 is anemic and perhaps already over. Keynesian policies will not bring an end to the current era of malaise, any more than they brought an end to it in the 1970s, because they retard economic growth.

## A Walk on the Supply Side

Economic growth as we experience it is a phenomenon of the last 200 years. Each generation of Americans has been materially richer than the previous one. Before that, however, economic growth was glacial—not experienced by people over the course of their lifetimes, but only visible over the course of centuries. It *had* occurred: The Founders lived better than their ancestors had lived in 1500 who, in turn, lived better than their ancestors had in 1000. But the pace of change was very slow, and it was subject to reversals that lasted not for months but for decades or centuries.

What changed beginning in the 18th Century was that technology was harnessed to increase productive capacity across the economy. Everybody understands the importance of technological change to this process, and we honor the inventors who developed the new technologies. But other changes, in the area of politics, law, and finance, were critical in harnessing the power of technology to enable large-scale economic growth. From Independence until the 1930s, the United States was one of the most lightly governed and taxed nations in the world. During most of the same period, government in Great Britain followed free-market policies. The burden of government during the period in which economic growth took off was unusually light. Before 1800, corporations were created by special legislation. Without a corporate charter, investors in a business put their entire net worth at risk by becoming partners in a venture. But in the early 1800s laws were adopted that permitted investors in businesses to put only the amount of their investment at risk. This development encouraged the investment of capital in new businesses, despite the risk they might fail, and thus gave them a chance to succeed.

During the early modern era, governments frequently granted monopolies to individuals or corporations or adopted other policies that restricted competition for the benefit of politically favored producers under the mercantilist theory that the balance of trade was the key to wealth. This became less common after 1800, due to the influence of Adam Smith and his successors. The decline of government intervention to limit competition encouraged innovation. Finally, following the examples set by the Netherlands and Great Britain in the 17th and 18th centuries, governments adopted policies that encouraged the growth of banking and financial markets. Alexander Hamilton's program was the American example. The resulting institutions helped move resources from less productive to more productive uses. Collectively, these policies, along with

advancing technology, kicked off the modern era of economic growth.

Keynesian economics, however, doesn't address these underlying institutional arrangements or the productivity they enable. It focuses on managing demand, primarily through government spending. In other words, it ignores the importance of innovation, which increases supply and creates wealth. Keynesian policies have unintended consequences, which reduce innovation and thus the growth of supply. The additional government activity Keynesians recommend may convey direct and visible benefits on constituents and improve economic statistics for awhile, but it indirectly harms the economy by discouraging the types of change that are necessary for productivity growth.

High marginal income tax rates were imposed in the 1930s and the 1940s to pay for expanded government. Because the additional revenues raised were offset by additional spending, from a demand management perspective, this should not have affected growth. But as a result, a larger share of investment was driven not by the economic returns, but by tax preferences, reducing the capital available to support innovation. Other New Deal policies reinforced the bias against innovation. Securities laws adopted in the 1930s were designed to protect investors by imposing rigorous disclosure requirements on companies seeking to raise capital through the public markets.

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The downside of these requirements, however, is that it is hard for smaller companies and companies without track records to comply. Securities laws thus disadvantage new enterprises. Furthermore, the New Deal regulatory state was founded on the belief that "excess competition" was a major cause of the Depression (because it drove down prices). This belief in managed competition continued in the post-war era, with an expanding share of the goods and services in the economy coming under some form of price regulation. As numerous people have observed, the tendency of regulated business to "capture" the regulators turned these regulatory regimes into anti-competitive bulwarks that made it harder for new methods and technologies to replace incumbents.

As the economy faltered in the 1970s, critics began to point out how these policies had undercut economic growth by inhibiting "creative destruction." To avoid high tax rates, an increasing portion of investment was being diverted by tax preferences in ways that made it less productive. The solution: cut tax rates. Securities laws were giving large existing businesses an unfair advantage in raising capital, thus stunting the growth of new competitors and industries. The solution: expand exceptions to securities disclosure requirements to permit sophisticated investors to make investments in non-public companies. Regulation was preventing competition from driving down prices in energy, transportation, communications, and other industries. The answer: deregulate, and watch prices plummet as new competitors force incumbents to match their prices or fail.

It worked. The stagflation of the 1970s gave way to the roaring recovery of the 1980s and the productivity boom of the 1990s. "Malaise" gave way, within five years, to "Morning in America." The growth wasn't driven primarily by the old corporate behemoths regaining lost market share but by new businesses and industries creating a new, more productive economy. The "New Industrial State" envisioned by John Kenneth Galbraith was replaced by the cult of the entrepreneur, and the prosperity that came with it.

## Lessons for Today

What are the lessons we should have learned from the experience of the 1970s, 1980s, and 1990s, and how do they apply to the problems of today?

**Lesson One: The future belongs to the new**. In 2000, the ten largest companies in the world (by market capitalization) were Microsoft, General Electric, NTT DoCoMo, Cisco Systems, Wal-Mart, Intel, Nippon Telegraph and Telephone, Exxon Mobil, Lucent Technologies, and Deutsche Telecom. Of those ten companies, seven were American. Four of them (Microsoft, Cisco, Wal-Mart, and Intel) were founded after 1967 and went public after 1970. None of these companies were ranked higher than 368th on the Fortune 500 in 1980. And it was those four companies—not the three left from the previous cycles—that were among the drivers in the economic boom of the 1990s.

Policy should be aimed at creating fertile ground for new businesses to grow, not at preserving existing giants. High taxes and expensive regulation deter the creation of new businesses and industries, while government subsidies tend to benefit existing businesses with lobbying clout. The bailouts and subsidies of recent years will not lead to the growth of tomorrow, they will retard it.

The lesson? We do not know what businesses and industries will drive growth over the next 20 years, but we can be pretty sure that the most important of them are not big today. Carl Shramm, president of the Ewing Marion Kauffman Foundation, which studies entrepreneurship, recently put the matter very succinctly:

> "The single most important contribution to a nation's economic growth is the number of startups that grow to a billion dollars in revenue within 20 years."

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**Lesson Two: The "new" comes from the private sector**. During the 1960s and 1970s, federal government officials spent tens of millions of dollars seeking to "break up" IBM, because it feared IBM would "monopolize" the computer industry of the future. They gave up in 1982. By 2000, four companies in the information-processing industry were among the ten largest companies in the world, primarily because of their domination of segments that did not exist in 1980. IBM was not one of them (it was 13th). And the federal government was suing the largest of those companies, Microsoft, because it feared Microsoft would "monopolize" the computer industry of the future.

The lesson? It is innovation in the marketplace, not the (very limited) foresight of government, that will create the wealth and jobs of tomorrow. Policy should not be focused on supporting particular businesses, technologies or industries or on managing competition in existing markets but on promoting a broadly competitive environment in which new ideas can be brought forward and succeed or fail on their own merits. We should replace subsidies, stimulus payments, and anti-trust suits with lower taxes and less regulation.

**Lesson Three: Creation requires destruction**. In 1970, when I was starting to listen to music, FM radio and cassette tapes were the emerging technologies,

but AM radio and records were dominant. Today, virtually nobody listens to music on AM radio, and records (and cassette tapes) are collectors items. I listen to music, mostly the same music, on CDs and satellite radio. Despite my preferences, there is now strong movement away from CDs toward digital music. According to the Recording Industry Association of America, CD sales declined from $11.4 billion in 2004 to $4.3 billion in 2009, while digital sales rose from $183 million to $2.0 billion. In each evolution of the music industry, various elements of the industry declined or died off to make way for a better consumer product and experience. Had government decided to protect the market shares of AM radio in the 1970s or recording industry CD sales more recently, consumers would be decidedly worse off.

The lesson? In order for new businesses to grow, old ones must die. The resources released by the failing businesses are better used and the customers of the failing businesses are better served by the businesses that replace them. When government follows policies that prop up existing businesses and industries, as tends to result from a Keynesian focus on demand, it retards the process of innovation that leads to growth. While government should play a role in helping displaced workers transition to new opportunities, it is economically counter-productive to follow policies that restrict the process of closing and replacing failing businesses.

**Lesson Four: Recessions are a normal part of the economic cycle**. In 1970, the United States experienced a mild recession after the great boom of the 1960s. President Nixon, concerned about re-election, applied Keynesian stimulus. When these policies triggered rising inflation in 1971, he imposed wage and price controls. He won the election, but the policies triggered a much deeper recession in 1974-75. After Jimmy Carter became president, the relatively cautious policies followed by the Ford administration were replaced by major increases in spending and the money supply. By 1979, rampant inflation forced the Federal Reserve to adopt double-digit interest rates, which triggered another recession. Carter, up for re-election in 1980, pressured the Federal Reserve to lower rates, and the "recession" (defined technically) ended, but not in time to save Carter's presidency. At that point, the Fed resumed the inflation fight, with President Reagan's backing, and stuck with it until inflation was tamed. Reagan adopted policies aimed at producing long-term growth rather than immediate relief. The recession was bruising, but it was allowed to run its course (see creative destruction above). The economy grew strongly for two decades afterward.

The lesson? The economy has ups and downs, but what matters is promoting long-term growth. During the down cycles, people lose jobs, and businesses fail. If we follow policies designed primarily to treat those symptoms, we may reduce the pain in the short term, but we find ourselves in greater difficulties before long. If, on the other hand, we follow policies designed to promote long-term growth, we reap the benefits of the pain we suffer during a recession.

**Lesson Five: Government must let markets solve economic problems**. In 1973, in the wake of the first Arab oil embargo, President Nixon launched "Project Independence," designed to free America from dependence on foreign oil by 1980. During the rest of the 1970s, the government spent tens of billions of dollars on alternative energy projects and promoting conservation. The speed limit was reduced to 55 to reduce gas consumption. Yet gas lines returned with the Iranian Revolution in 1979. When Ronald Reagan became president in 1981, he deregulated oil prices and went on to promote deregulation of energy markets throughout his two terms in office. None of the projects launched by Presidents Nixon and Carter existed on the 20th anniversary of Reagan's election. None of the technologies subsidized during those years contributes more than a small fraction of our energy today. Moreover, despite instability in the Middle East and substantial economic growth, there have been no gas lines since 1980.

The lesson? Problems that involve the allocation of limited resources to satisfy unlimited desires are

economic problems. Government has a very poor record of solving economic problems. Keynesian economic thinking reinforces the natural tendency of politicians to "do something," which leads to government interventions that generally do more harm that good. Markets, on the other hand, have a very good record of solving economic problems. Supply side policies are explicitly based on leaving economic problems to markets.

## Applying the Lessons

The economic policies followed by the federal government since the current financial crisis began have ignored these lessons. The dominant policy objective has been to restore the *status quo ante*. But the reason for the mess we're in is that the economy of the "bubble years" was unsustainable. Spending was based on borrowing, primarily against homes at increasingly inflated values, rather than increases in productive capacity. At the peak of the bubble, Americans were borrowing at an annual rate of about $1 trillion against their home equity, primarily to finance current consumption. Most of this spending did not produce anything; it consumed wealth. Yet it showed up as growth in our economic statistics.

Our primary measure of the size of the economy is "gross domestic product," which is a measure of the country's overall income. Keynesian policies seek to increase GDP directly by increasing demand. Borrowing money to spend on nonproductive activities may produce income in the year the money is spent, but it does not produce any recurring income.

Our primary measure of the size of the economy is "gross domestic product," which is a measure of the country's overall income. Keynesian policies seek to increase GDP directly by increasing demand. Borrowing money to spend on nonproductive activities may produce income in the year the money is spent, but it does not produce any recurring income. It doesn't matter if that borrowing and spending is done by individuals, as in 2006, or by the government, as in 2010. Real growth is the result of improved productivity—of activity on the "supply side" of the economy.

Government's efforts to replace private consumption have, if anything, undermined the economy's return to growth. Three years after the financial crisis began, residential real estate remains a sick industry, because the government has followed policies that have kept prices from falling to market-clearing levels. As a result of bailouts and the Federal Reserve's "zero interest rate" policies, failed banking enterprises remain in business, utilizing resources that should be re-allocated to other, more successful financial businesses or to other parts of the economy. Government at all levels continues to promise people future benefits it cannot afford to provide, using "stimulus" dollars to postpone the necessary reconciliation between revenue and spending.

So what should we do instead?

The supply-side remedy to the current economic malaise is to focus on freeing resources to pursue returns through improvements in productivity. Thirty years ago, inflation and high marginal tax rates were the primary policy obstacles. Today, the situation is more complicated. There are at least five areas where new policies are necessary to re-orient our economy toward a more productive future:

**1) Monetary Reform**. The Federal Reserve did the right thing in aggressively pumping liquidity into the financial system in 2007-08 to prevent

the mortgage market collapse from setting off a deflationary spiral like that of the 1930s. But it created the circumstances that led to the mortgage bubble earlier in the decade by keeping interest rates artificially low to blunt the recession that followed the collapse of the tech bubble and 9-11. It has followed policies that are postponing the necessary resolution of the excesses of the bubble era, both by bailing out specific financial businesses and by continuing to follow zero-interest-rate policies to enable the banks to recover the losses incurred during the collapse.

Both sets of mistakes follow from an inflationary bias that is inherent in the Federal Reserve's current mandate to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates," as well as from the Federal Reserve's desire to protect the banks it regulates. In order to balance its somewhat contradictory goals for monetary policy, the Federal Reserve has defined "price stability" in a way that is inherently inflationary. First, the Federal Reserve measures inflation by reference to the consumer price index, which has led it to ignore inflation in types of prices not included in the CPI (e.g., the price of residential real estate and commodity prices; see below). Second, the informal inflation target has been set at 2 percent per annum, which means that the Fed has defined "stable prices" to mean inflation of nearly 25 percent each decade. This arises from an inordinate fear of mild price deflation, which the Fed associates with Japan's lack of growth over the past two decades. Historically, however, economic growth has continued during periods of mild deflation, such as during the later years of the 19th Century.

From January 2000 to January 2010, the price of gold went from $284 to $1,117 per ounce, the price of oil went from less than $23 to $74 per barrel, and the price of copper went from $1,670 to $6,980 per ton. Real estate prices experienced an unprecedented bubble, although they subsequently collapsed. Most significantly, the value of the dollar has fallen against other major currencies, despite investors' growing preference for the relative political stability of the United States. All of these developments were fed by the same fuel—easy money created by the Federal Reserve. All of these trends distort the investment environment, undercutting investments in improved productivity and encouraging speculation based on the expected changes in asset prices in response to a fluctuating dollar.

We need to move the Fed away from the impossible task of managing the economy and toward the achievable goal of maintaining the value of the currency. If the Federal Reserve managed to maintain a stable dollar, our underlying economic problems would for the most part be resolved by markets.

The solution? Narrow the Federal Reserve's mandate to maintaining the value of the dollar and limit its responsibilities to those that enable it to implement that mandate. The recent financial reform law goes in the opposite direction, giving the Federal Reserve a greater responsibility than it had before for managing the financial sector. We need to move the Fed away from the impossible task of managing the economy and toward the achievable goal of maintaining the value of the currency. If the Federal Reserve managed to maintain a stable dollar, our underlying economic problems would for the most part be resolved by markets.

2) **Budget Reform**. Our federal budget process does not work. Not only is there no requirement for a balanced budget and no requirement to accrue for long-term liabilities, but there is no effective control mechanism for the current one-year, cash-basis budget. As a result, society's interest in limiting

the amount of its resources spent by government is frequently ignored in the budget process.

From a supply-side perspective, it is imperative to limit the size of government. From 1980 through 2000, federal spending ranged from 18.8 percent to 23.2 percent of GDP.[1] Total government spending ranged from 33.9 percent to 38.7 percent of GDP.[2] During that period, the U.S. economy grew by approximately 93 percent.[3] By way of contrast, government spending in the largest European countries (Germany, France and Italy) ranged from 41 percent to 56 percent, and growth over the period 1980-2000 ranged from 48 percent to 55 percent.[4] The inverse relationship between the size of government and economic growth is clear. Unfortunately, in recent years we have moved toward a European level of government spending. In 2010, spending at all levels of government in the United States is projected to exceed 41 percent of GDP, with federal spending exceeding 25 percent of GDP.[5]

We need to move back toward the lower level of government spending that permitted growth over the prosperous decades of the 1980s and 1990s. The top budget priority of the federal government, except during times of declared war, should be to avoid consuming a share of the nation's resources that retards growth. To implement this, we need a new Budget Act that reduces federal spending to 20 percent of GDP over the next few years and then caps it at that level (except during declared wars). If federal spending this year were 20 percent of GDP instead of 25 percent, it would be lower by approximately $800 billion. The reduction would make additional resources available to the private sector of the economy, where they could be devoted to increased productivity and thereby spark renewed economic growth. In addition, as investors regained confidence that future earnings were not going to be taxed at confiscatory rates to pay for unlimited government, they would be more inclined to take the risks that lead to productivity growth. Critically, establishing a cap on Federal spending at 20 percent of GDP—one dollar for every five dollars of income earned in the economy—would create a simple measurement of the size of government to which voters could hold political leaders responsible. Since a spending cap imposed by legislation could be circumvented by subsequent legislation, it is important that voters be able to hold the President and Congress responsible for living within the cap.

> The Progressive narrative of the financial crisis starts with the premise that the United States followed "de-regulatory" policies during the Bush Administration, which led to the excesses that caused the crisis. This is simply not true. No major de-regulatory legislation was passed during George W. Bush's two terms.

How would the process work? Before the start of each fiscal year, the government would estimate GDP for the coming year and divide that number by five. That would be the maximum amount government could spend during the coming year. The president would then submit a budget, and Congress would pass appropriations and other spending legislation, subject to the cap. If Congress voted (either with

[1] Office of Management and Budget, *Historical Tables: Budget of the U.S. Government Fiscal Year 2011*, Table 3.1, available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf.

[2] Organisation for Economic Co-operation and Development, National Accounts at a Glance Database (2009 edition), at http://stats.oecd.org/Index.aspx?DataSetCode=NAG.

[3] Id.

[4] Id.

[5] Organisation for Economic Co-operation and Development, OECD Economic Outlook 86 Database (December 2009), at http://stats.oecd.org/index.aspx; and Office of Management and Budget, *Historical Tables: Budget of teh U.S. Government Fiscal Year 2011*, Table 3.1, available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf.

the president's approval or over his veto) to spend more than permitted, the president would be required to determine which spending to curtail to bring the total down to 20 percent of GDP. This would be similar to the unallotment authority Gov. Pawlenty asserted in 2009, but it would be explicitly authorized by statute. Similarly, if during the year the estimate for GDP decreased, the president would have the authority to make adjustments to stay within the cap. This would work the way the Governor's unallotment authority currently works in Minnesota. The current bias toward spending just a little bit more on whatever is in today's news would be checked by the knowledge that each dollar of new spending would have to replace, rather than be added to, the trillions of dollars of existing spending.

**3) Get government out of the business of trying to direct economic activity**. Although the United States remains a market-based economy in most respects, the role of government in our economy is significant. The recent meltdown in the housing market exposed the extent of government intervention, particularly in the form of subsidies for mortgage lending. Two "government-sponsored enterprises"—Fannie Mae and Freddie Mac—together either own or guaranty about half the outstanding mortgage debt in the country. Their losses will be borne by taxpayers. Other government programs support a significant portion of the remaining debt. The costs to the government because of the insolvency of Fannie and Freddie will dwarf the costs of the Toxic Assets Relief Program (TARP), the infamous bank bailout, and other federal programs supporting mortgage lending will also experience losses. Other sectors of our economy are also laced with subsidies, including agriculture, energy, and transportation. That is before we get to the sectors that are dominated by government, such as health care and education. The tax code is littered with subsidies for particular businesses or industries. During the 2008 financial crisis, the government directly invested in or provided guaranties to save commercial banks, investment banks, an insurer, and two auto companies. Although most of our property remains in private hands, a substantial portion of economic activity is insulated from market discipline by this web of subsidies.

The Progressive narrative of the financial crisis starts with the premise that the United States followed "de-regulatory" policies during the Bush Administration, which led to the excesses that caused the crisis. This is simply not true. No major de-regulatory legislation was passed during George W. Bush's two terms. Instead, Congress enacted the Sarbanes Oxley Act in response to the Enron and WorldCom fraud scandals, which added material compliance burdens for all U.S. publicly traded companies, and disproportionate burdens to smaller companies. Subsidy programs were expanded in the areas of housing, agriculture, and energy. Regulatory spending increased 30 percent (on an inflation-adjusted basis) during the Bush Administration, and employment in the regulatory agencies increased more than 40 percent. The U.S. Supreme Court ruled that the Environmental Protection Agency (EPA) was obligated to consider regulation of carbon emissions, notwithstanding its determination to defer regulation due to scientific uncertainty and policy considerations. Far from being an age of de-regulation, the Bush years saw a considerable expansion of the government's role in the economy. And, needless to say, the trend has accelerated dramatically under President Obama.

Each of the subsidies and tax incentives has the effect, and many of them have the express purpose, of diverting investment into politically favored channels. This diversion is harmful to productivity. Each of the new regulatory burdens imposed on business, regardless of its merits, diverts resources that could be used to expand productivity. In order to spur a new age of productivity growth, we should take a machete to the entire morass of regulations and subsidies that the government uses to direct our economy. Specifically, we should do the following:

- Repeal all laws, decisions and regulations that impose material burdens on business adopted since January 20, 2001, with the exception of limitations on banking activities

that reduce the risk of future bailouts. This would include Sarbanes-Oxley, much of the recent Dodd-Frank bank regulatory reform act, and the EPA's carbon "endangerment" finding (and the related Supreme Court decision).

- Review all government loan guaranty programs, including indirect guaranty programs (such as the "government-sponsored enterprises" that borrow money on the basis of an implicit government guaranty and then make loans), and phase them out. Where these programs serve a social (rather than economic) purpose, we should find ways to replace them with direct subsidy programs so that the cost of the subsidies is included in the government's annual budget.

- Review all direct and indirect government subsidy programs for businesses, including special tax preferences, and phase them out.

- Liquidate all government investments in businesses that compete in private markets, including TARP (Troubled Asset Relief Program) investments and the portfolios of government-sponsored enterprises that rely on implicit government guarantees for funding.

The primary purpose of these changes is not to save the government from losses, although that's an important secondary purpose. The primary purpose is to remove political incentives that channel investment away from productivity growth.

**4) Health Care Reform**. In 2009, health care accounted for 17.3 percent of GDP and 22 percent of federal spending in the United States.[6] It has been the fastest growing item for both Federal and state budgets over the last decade. We cannot implement budget discipline without coming to grips with health care spending. Moreover, the biggest single sector of the economy that could benefit from the productivity improvements that characterize competitive markets is health care.

Health care is the largest sector of our economy that is based primarily on a third-party payment system (i.e., somebody else pays for the services we receive). Not only do health "insurance" policies (unlike other insurance policies) cover routine expenses, but the health care field is littered with statutes, rules, and regulations that require third parties to pay for services without regard to whether the service would be worth the price to the patient. Because the price paid by patients has almost no relationship to value, service providers have little incentive to try to keep them from rising. Instead, the incentives are to make sure that when you provide a service somebody other than the patient (either an insurance plan or the government) is required to pay for it. Is it any wonder that health care is also the one area of the economy where the technology revolution of the last generation has resulted in higher prices instead of lower prices?

Unfortunately, health care policy in recent years has moved us in the wrong direction. In 2003, a Republican Congress and administration created the largest new entitlement program since 1965 when they passed Medicare Part D. Unlike the original Medicare, Part D was enacted with no source of revenue. Even though Part D includes incentives that have kept spending below the levels projected when it was enacted, the legislation did not apply those incentives to control costs in the existing parts of Medicare and Medicaid. Instead, it was a pure "add on" to the existing programs. Not to be outdone, this year a Democratic Congress and administration passed a bill to overhaul the entire health insurance industry, not to create incentives for more efficient use but to further dilute the connection between the health care services people receive and the amount they pay.

So what should we do to reform health care, both to

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[6] Centers for Medicare & Medicaid Services, *National Health Expenditures Fact Sheet*, at https://www.cms.gov/NationalHealthExpendData/25_NHE_Fact_Sheet.asp; Office of Management and Budget, *Historical Tables: Budget of teh U.S. Government Fiscal Year 2011*, Table 3.1, available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf.

reduce the pressures on government spending and to introduce productivity growth in the sector that would allow us to receive better care for less money? The first step is to repeal Obamacare, but that is not a solution. Literally hundreds of ideas have been proposed, but the basic principles for creating a working health care market are the following:

- Move toward high deductible insurance plans under which individuals pay ordinary health care expenses. When you buy insurance for your home or car, you don't expect it to cover routine maintenance. It is there for unexpected expenses. If we applied the same principle to health care insurance, people would have an incentive to spend their health care dollars more carefully, and providers would have an incentive to offer value to patients. Those are the building blocks of an effective market.

- Eliminate the tax incentives tying health insurance to employment. Under current law, which has been in effect since World War II, employee health insurance plans are tax deductible to employers and tax free to employees. That is why we get our health insurance through our jobs, rather than buying it in a competitive market. We need to reverse this policy and provide the same tax treatment to health care expenditures whether made by employers or individuals. This would have several benefits, one of the most important of which would be to eliminate the incentive for people to stay in a job they should leave just in order to keep their health insurance.

- Repeal mandates that insurance policies cover particular, non-essential services. These laws are in effect at the federal level and in all states and are there to benefit health care providers, not patients. Individuals should have the ability to choose which non-essential services they want to have insured. The only services that should be mandatory in health plans are those that hospitals are required to provide regardless of a patient's ability to pay.

- Permit insurers to compete across state lines. Today's health insurance market is Balkanized because each state is a separate market. When combined with state-level mandates, the prohibition on interstate competition leads to situations where the cost of a basic individual insurance policy varies dramatically from state to state. Interstate competition would eliminate these anomalies.

- Make health care pricing transparent. When a client goes to a lawyer, the client asks up front what the charge will be for the services. Clients may not get an exact dollar price, but they will understand how they are going to be charged. The same principle applies to other service providers, from auto mechanics to swimming instructors to landscapers. When patients go to a doctor or a hospital, however, they have no idea how much the services cost. Instead, they find out whether their insurance covers the services and how much, if any, of the cost they will pay directly. The doctor or hospital will have cut a separate deal with the insurance company, under which the company will pay an amount that may have little or no relationship to the value of the services to the patient.

- Transform government healthcare programs to conform to a market paradigm. Federal programs account for almost 35 percent of all health-care spending, and state and local government programs account for an additional 12 percent.[7] We cannot implement a market-based health care finance system without reforming the government programs. Fortunately, there are models on which to base these reforms. In particular, the health plans provided to state employees in Minnesota have effectively created incentives to control costs.

[7] Centers for Medicare and Medicaid Services, U.S. Department of Health and Human Services, National Health Expenditure Data, available at https://www.cms.gov/NationalHealthExpendData/.

It can work. There are corners of the health care marketplace, such as laser eye surgery, that fall outside of our current third-party payment system. In those corners, we have seen prices decline and quality improve as technology has advanced. There are also "national" health programs, such as Switzerland's, that are premised on patient responsibility for the costs of ordinary care. We must redesign our health care system around a market model that works. Once we do that, the escalating costs that have characterized health care over the past half century will come under control.

The basic principles of supply-side tax reform are simple: lower rates; eliminate tax preferences that distort economic activity; eliminate double taxation. The basic arguments against supply-side tax reform are always the same: a public outcry that lower rates constitute a "giveaway to the rich" that will deprive the government of needed revenue, combined with intense private lobbying to preserve or expand tax preferences.

**5) Tax Reform**. A "supply-side" economic program must have a tax component, and this one is no exception. The basic principles of supply-side tax reform are simple: lower rates; eliminate tax preferences that distort economic activity; eliminate double taxation. The basic arguments against supply-side tax reform are always the same: a public outcry that lower rates constitute a "giveaway to the rich" that will deprive the government of needed revenue, combined with intense private lobbying to preserve or expand tax preferences.

When Ronald Reagan took office in 1981, the top marginal income tax rate was 69.125 percent.[8] After the 1986 Tax Reform Act took effect in 1988, the top marginal tax rate was 28 percent. After the Clinton tax increases took effect in 1993, the top marginal rate had been raised to 39.6 percent. And if the Bush tax cuts are allowed to expire in 2012, the top rate will be restored to that virtually 40-percent level. A look at the revenue streams produced (or projected) in each of those years sheds light on the merits of the public arguments against supply-side reform.

| Fiscal Year | Top Marginal Rate[9] | Individual Income Tax Revenue (as a % of GDP)[10] | Share of Income Taxes Paid by Top 1%[11] |
|---|---|---|---|
| 1981 | 69.125% | 9.4% | 17.6% |
| 1988 | 28% | 8.0% | 27.6% |
| 1992 | 31% | 7.6% | 27.5% |
| 1994 | 39.6% | 7.8% | 28.9% |
| 2007 | 35% | 8.4% | 40.4% |
| 2012 | 39.6% | 8.2% (Est.) | N/A |

The tax cuts of the Reagan era did materially reduce the share of GDP raised by income taxes, from 9.4 percent to 8.0 percent. That 1.4 percentage-point decrease, however, is a small fraction of today's fiscal gap. The percentage did rise a pinch after the Clinton rate increases took effect and more substantially as the economy boomed in the late

[8] While the top marginal income tax rate was 70 percent in 1981, a statutory tax credit effectively brought the rate down to 69.125 percent.

[9] For a history of tax rates, *see* Robert A. Wilson, "Personal Exemptions and Individual Tax Rates, 1913-2002," Statistics of Income Division, Internal Revenue Service (2002), available at http://www.irs.gov/pub/irs-soi/02inpetr.pdf; and Tax Foundation, *U.S. Federal Income Tax Rates History, 1913-2010* (Sept., 23, 2010), available at http://www.taxfoundation.org/publications/show/151.html.

[10] Information on tax revenue as a percentage of GDP is from the Office of Management and Budget, *Budget of the United States Government: Historical Tables Fiscal Year 2011*, Table 2.3, available at http://www.gpoaccess.gov/usbudget/fy11/pdf/hist.pdf.

[11] Information on the share of income taxes paid by the top 1 percent of taxpayers by income is from the Tax Foundation, *Summary of Federal Individual Income Tax Data* (October 2010), available at http://www.taxfoundation.org/publications/show/23408.html; and Internal Revenue Service, Individual Income Tax Returns with Positive Adjusted Gross Income Returns Classified by Tax Percentile, Early Release (July 2010), at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html.

1990s. The proposed restoration of those rates in 2012 will not be enough to offset the revenue loss resulting from the current recession. The effect of raising income tax rates on revenue is limited. As far as the progressivity of the income tax system, the top one percent of taxpayers has paid more over the years, whether maximum marginal rates dropped or increased. In 2007, the top one percent paid over 40 percent of all income taxes, in spite of the Bush tax cuts. Clearly, taxpayers (and higher-income taxpayers specifically) respond to higher rates by finding ways not to pay them. Those actions distort investment away from productivity growth, while the higher rates fail to solve the government's fiscal problems and are not necessary to maintain a progressive income tax system.

As part of his "Roadmap for America's Future," U.S. Representative Paul Ryan has included a proposal for a supply-side income tax code. Ryan's proposal discards our current complex tax code, replacing it with a simplified system that would do far less to direct economic activity. Ryan's proposal:

- Provides individual income tax payers a choice of how to pay their taxes—through existing law or through a highly simplified code that fits on a postcard with just two rates and virtually no special tax deductions, credits, or exclusions (except the health care tax credit).

- Simplifies tax rates to 10 percent on income up to $50,000 for individuals and $100,000 for joint filers and 25 percent on income above these amounts.

- Includes a generous standard deduction and personal exemption (totaling $39,000 for a family of four).

- Eliminates the alternative minimum tax.

- Replaces the corporate income tax—currently the second highest in the industrialized world—with a border-adjustable business consumption tax of 8.5 percent. This new rate is roughly half that of the rest of the industrialized world.[12]

If Ryan's proposal were adopted, it would go a long way toward eliminating politically motivated tax incentives that distort economic behavior and slow economic growth. If the revenue raised under this tax regime were inadequate to fund a reduced level of government, it could be supplemented by consumption taxes that would not distort investment incentives.

Income tax reform is not the only way in which our tax system could be improved to reduce the drag on productivity. Payroll taxes (primarily for Social Security and Medicare) currently account for slightly more than 40 percent of federal revenue. These taxes add to the cost of goods and services produced in the United States, placing a huge burden on the supply side of our economy. We ought to start replacing payroll taxes with consumption taxes.

## Conclusion

America's response to the economic crisis that followed the bursting of the housing bubble has been based on economic theories that were discredited in the 1970s, and has ignored the lessons of the prosperous decades of the 1980s and 1990s. If we are to restore our economy to growth, it is important that we understand not just how to avoid the cataclysmic mistakes of the early 1930s but also how to avoid the stagnation of the 1970s and encourage the type of growth we experienced from 1983-2000. Recent history contains a shining example of how to kick-start a stagnant economy. We ought to learn from that example. ■

[12] The term "border adjustment" of taxes refers to the removal of certain domestic taxes imposed by exporting countries on goods and services moving in international trade and the parallel imposition of such taxes on imported goods. *See* Hufbauer and Gabyzon, "Fundamental Tax Reform and Border Tax Adjustments," *National Tax Journal*, vol. 49 (1996): 687, 688.

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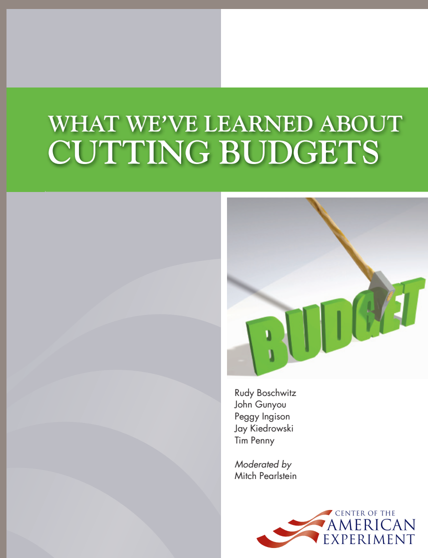


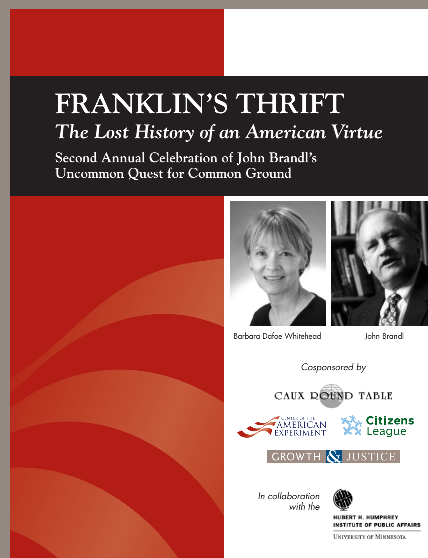


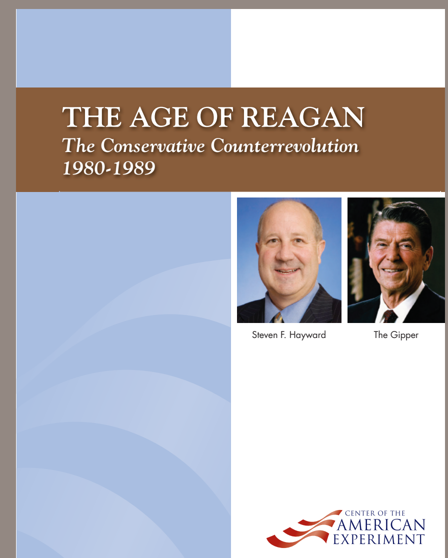


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