Supply-side Believers
By Jim Pasero

In our December editorial, “Bleeding Red; Going Green,” we wrote, “The last 75 years of American political history is defined by two eras: the age of liberalism (1932 to 1980) from Roosevelt to the defeat of Jimmy Carter, and the age of conservatism (1980 to 2008) from Reagan to the defeat of John McCain.”

With the election of Barack Obama, gone — at least for this moment in history — is the recent era of conservatism and with it the popularity of an economic theory known as supply-side economics. It is worth noting, however, that the very same politicians who were certain that supply-side dollars in the private sector would not trickle down to the public are now convinced to the tune of $825 billion that Keynesian government-spent dollars will surely trickle into the public’s pockets.

The two most important pillars of Ronald Reagan’s presidency were his arms build up to counter Soviet aggression and his implementation of supply-side economic theory. At the time, supply-side theory — cutting marginal tax rates to increase economic growth — was considered reckless. But after a generation of success, the unorthodox approach became orthodox. Keynesian economics — stimulating demand through government spending — was the dominant economic theory of the post-war age of liberalism, and it seemed archaic in the new age.

The era of supply-side economics began in 1974 when its champion, Arthur Laffer, had dinner at a Washington, D.C., restaurant with President Ford’s chief of staff and deputy chief of staff, Don Rumsfeld and Dick Cheney, along with former *Wall Street Journal* associate editor, Jude Wanniski. Writes Laffer about the dinner, “While discussing President Ford’s ‘WIN’ (Whip Inflation Now) proposal for tax increases, I supposedly grabbed my napkin and a pen and sketched a curve on the napkin illustrating the trade-off between tax rates and tax revenues. Wanniski named the trade-off the ‘Laffer Curve.’”

The successful implementation of the Laffer Curve took place during the Reagan years and, for the most part, was not repealed during the Clinton administration. It was tried again successfully during the first six years of George W. Bush’s administration. However, during the last few years, even before the 2008 financial crisis, supply-side economics began to pick up some influential critics, including Warren Buffet and *Financial Times* columnists Larry Summers and Samuel Brittan.

America’s most recent period of economic expansion from 2001-2007 saw record corporate profits while incomes remained flat or declined. The recent expansion was the first in the post-war era in which incomes did not keep pace with corporate profits. Why? The question has bothered many economists. Why did incomes remain flat, especially since unemployment figures were at historically low rates? Why was wealth more concentrated in the top 20 percent of Americans than any other time in a century? Was it because of technology breakthroughs in the 1990s? Did the IT revolution not have enough time to trickle down? Was it globalization? Were global profits kept by corporate

leaders while production was spread more evenly across the world? When answers weren't definitive, patience waned among policymakers for an economic theory that had promised all would benefit when marginal tax rates were lowered.

"All economic ideas are a reflection of the times in which they are born," says Phil Romero, dean of the College of Business and Economics for California State University, Los Angeles. Keynesian economics came out of a time when the orthodoxy was that economies were self-correcting, which was the way Hoover played his term in office.

"Keynes realized that when demand falls too far below supply you need someone with big pockets to stimulate the economy — big pockets like the government. It worked well for a generation. By 1960, economists thought they could fine tune the economy and eliminate recessions. But confidence turned to hubris when LBJ ran large deficits and devalued the dollar, accelerating inflation," says Romero.

Toss in a couple of oil shocks in the 1970s and Americans entered a decade of stagflation where stopping inflation meant slowing the economy, and stimulating the economy meant debasing the currency. Enter supply-side economics and the Laffer Curve. "Supply-side worked like a charm for 20 years," says Romero, "from the early 1980s to 2000."

The strengths of the theory began to wind down this decade when a world savings glut brought a period of low interest rates, a negative yield curve and then, of course, the housing bubble. "The bubble in this decade was inflated by foreign savings, foreign ownership of American assets. And as the federal government and some states borrow more and more, that will just accelerate that trend," says Romero. "In the long run those governments will have to reverse course and run surpluses and that will mean higher taxes."

Tim Duy, University of Oregon economics professor and author of the Oregon Index of Economic Indicators, is not a fan of supply-side economics, and he doesn't believe in the Laffer Curve. "Reagan proved that deficits don't matter, especially if Japan and China were willing to buy up the debt — that made everything work for 25 years."

Duy, like a growing school of economists, believes that it was Clinton's economic choices, not supply-side theory, that caused America to run a budget surplus in the late 1990s. "None of the bad things that people expected from the deficits of the 1980s occurred because of Clinton and the IT industry," says Duy. "Clinton partially raised taxes and the IT boom drove revenue growth, and after the GOP took control of Congress, there were no substantial spending opportunities."

So what's gone wrong in this decade? It wouldn't be a stretch to say that Duy partially blames it on a return to supply-side theory under President George W. Bush. "Most people are willing to admit that median incomes have not kept up with GDP growth," he says. "A huge amount of benefits have accrued to a relatively small population."

Duy then asks some tough questions about supply-side economics that pertain to this decade. “How does wealth become concentrated? How do policies encourage wealth concentration? What kind of tax cuts do that?”

Duy takes his criticism of supply-side economics beyond tax policy to a broader condemnation of past policies. “I believe that runaway global capital flows, where there is a propensity for China to manage them while we won’t, have distorted global patterns of production and consumption.”

This view, which is becoming more and more popular, is a fancy way of saying that Americans don’t manufacture products anymore. As a result of what Duy calls runaway capital flows, he now believes that the case for free trade has been undermined.

Ralph Shaw, former chairman of the Governor’s Council of Economic Advisors in Oregon, is more bullish about supply-side economics. “Supply-side economics worked for over 20 years and worked well,” says Shaw. “It opened up opportunities in areas that had not previously been developed.” But he adds, “Like every theory, when it works for a long time we lose our sense of fear that demands that we do our homework and think rationally.”

Shaw has been through a couple of economic bubbles and downturns in his life. He doesn’t blame our recent trouble on supply-side theory, but rather on the inevitable screw-ups of human nature.

“Providing capital to the private sector leads to the development of adequate supply and then leads to excess supply, as people believe they don’t have to do the homework of matching future demand with future supply. What you have,” says Shaw, “is people who see a trend analysis that shows certain areas of the economy growing quickly. Then consultants read this and bring investors and companies into those sectors. Industries often use irrational thought and analysis. No economic philosophy can legislate an absence of greed or shallow thinking.”

As for incomes not growing in the last decade, Shaw doesn’t blame it on supply-side theory or globalization, but on our educational system instead.

“A third of our students who enter high school are not graduating. How can you expect that one-third to contribute enough to the economy that they can make a real economic contribution and achieve a good standard of living?”

As for the current Keynesian mantra? “Keynesian economics does have a place — all this money will lead to increased demand,” says Shaw. “It will lead to products, roads. And changes related to Keynesian theory will bring mortgages down and make homes available, and then people will measure the cost and look at going forward. It will also lead to very high budget deficits and the declining value of the U.S. dollar, but that won’t be the topic until this very serious recession is done.”

Romero, having been an occasional lunch partner of Arthur Laffer, also remains a believer in supply-side economics, with this caveat. "Every economic school that's sensible has its place in certain historical circumstances. Keynesian economics is necessary during deep recessions, and supply-side economics is what you should be doing in between those recessions."

***BrainstormNW* February 2009**