Insights
DECEMBER 1999

# Failing To Learn the Lessons of History

BY LAWRENCE A. HUNTER

'Tis the season for retrospection, and especially on this eve of the year 2000, many people will be trying to gain some perspective by looking back.

Not that many years ago, the U.S. economy was out of control, and policy makers helplessly flailed about from theory to theory in hopes of stabilizing the economy, much less locking-in a healthy economy for the long term. But today, we have such an economy, and more importantly, we have learned through experience what works and what doesn't. Yet, amazingly, today policy makers seem to be forgetting some of those lessons, and are pursuing policies that are out-of-line with the lessons of recent history.

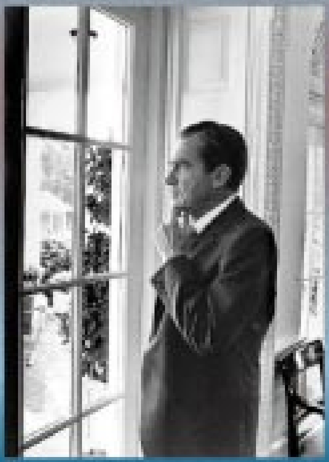
The current debate over the use of the surplus, protecting Social Security and Medicare, and tax cuts is in some serious need of historical perspective and clarity. Let's look back over the last 20 years and see what we have learned, what has worked and what hasn't, in an attempt to gain some notion about where we should go from here.

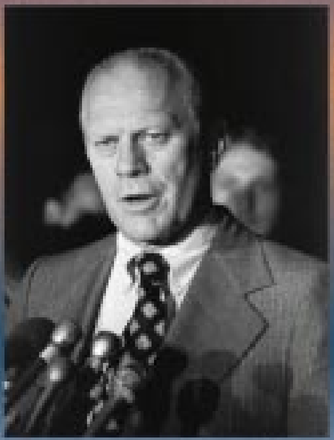
## Nobel Prize-Winning Ideas Have Consequences

In the 1970s, the U.S. economy was caught in a spiral of economic stagnation, rising unemployment, high interest rates and accelerating inflation that became known as "stagflation." Economists could neither explain stagflation nor offer an effective cure. They were trapped inside the "Phillips Curve," which maintains that too much economic growth of necessity produces increased inflation.

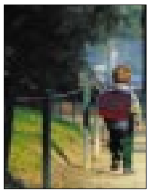
Because of this belief in the Phillips Curve, policy makers repeatedly tried to solve stagflation with tax increases, easy money, public-service employment and income redistribution programs. These all failed, repeatedly. A desperate Richard Nixon even imposed wage-and-price controls, which only made matters worse.

Then along came an obscure economics professor from Canada named Robert A. Mundell, who argued that loose monetary and tight fiscal policy should be reversed and that markets should be allowed to work freely. Mundell advised policy makers to stop printing money and to dramatically lower tax rates to increase the rewards to work and the returns on investment. If that meant temporary budget deficits, even large ones, the additional economic growth that would be produced would generate more than enough new revenues to pay the additional interest the government might incur. Thus would the net economic benefits of tax rate reductions exceed their cost in economic terms.





**INSIDE:**
Can We Be Rescued From Bad Regulations?



**ALSO:**
The Long Road Toward Education Reform

### THE SUPPLY-SIDE REVOLUTION

In 1976, a third-term congressman named Jack Kemp was introduced to Mundell's ideas. Kemp was no economist but he knew there were too many unemployed workers in his congressional district, and that those who had jobs were paying taxes at rates once reserved for the very rich. He embraced Prof. Mundell's ideas and proposed cutting income tax rates 30 percent across-the-board.

When Congressman Kemp presented these ideas to presidential candidate Ronald Reagan in 1979, Reagan too understood immediately what policies were required to advance the country toward economic recovery and prosperity. Jude Wanniski popularized Mundell's ideas by writing about them in the *Wall Street Journal*. Ronald Reagan won the 1980 presidential contest by promising to revive the economy with a supply-side economic program.

The proof of the policies was in their application by President Reagan and Fed Chairman Paul Volcker. By 1986, it was clear that the tax rate reductions and sound monetary policy were working to revive economic prosperity, and a second round of tax rate reductions created a two-rate tax code of 15 and 28 percent.

### SUPPLY-SIDE VS. AUSTERITY ECONOMICS

Unfortunately, this second supply-side treatment was contaminated by the "deficit hawk's" preoccupation with budget deficits and by their refusal to take into consideration the "dynamic" supply-side effects that tax rate reductions have on federal revenue. This new "Austerity Economics" resulted in the 1986 increase in capital gains tax rates and an ill-conceived expansion of the tax base that tightened the tax noose around the necks of savers, investors and producers.

Austerity began to take its toll during the Bush administration. The economic momentum generated by the earlier Reagan policies had concealed the damage being done by the 1986 tax "reforms" and kept overall GDP growing nicely for a few years after 1986. In 1990, however, the chickens began coming home to roost. The commercial real estate market, pincered between the Bush Administration's excessive new regulatory legislation imposed on financial institutions and the 1986 tax "reforms," collapsed. The country went into the most wrenching financial crunch since the Great Depression.

Even though the deficit was falling, it did not fall fast enough for the deficit hawks. Democrats continued wrongly to blame deficits on the Reagan tax rate reductions, and a substantial proportion of the GOP agreed with them. By the end of the 1980s, an anti-debt obsession reigned supreme in Washington.

This obsession led President George Bush, who had run his presidential campaign on a "no new taxes" pledge, to renege on his promise and sign into law the largest tax increase in history. The austerity counter-revolution was in full swing. But rather than reducing the deficit, the Bush tax rate hike helped push the economy into recession, which in turn caused the deficit to spike *upwards*.

Austerity economics sank George Bush, but it became the new Establishment orthodoxy. Politically, the Bush tax rate increase constituted a watershed, marking a reversal of the trend Ronald Reagan established of reducing tax rates.

### AUSTERITY ECONOMICS BECOMES LAW

The 1990 budget agreement also imposed the so-called "pay-as-you-go" budget rules, which required offsetting spending reductions or tax increases to "pay for" any future tax reductions. *This provision codified austerity economics into law* and doomed any prospect of significant tax rate reductions before the budget was balanced. Even though President Reagan's application of supply-side economics had saved America's economy from catastrophe in the 1980s, it was replaced in the 1990s by a throwback to the economic thinking of Herbert Hoover in the 1930s.

In 1994, voters gave control of Congress to Republicans. Thereafter, mercifully, Congress and the president refrained from any additional tax shenanigans and maintained reasonable (if not perfect) control over spending growth, the Fed squelched inflation, and the economy had an opportunity to recover fully. By 1996, the economy was expanding again by more than three percent a year. The deficit was in a free fall. In 1997, for the

first time in almost a decade, Congress again embraced supply-side thinking and cut the capital gains tax rate and created Roth IRA. For two consecutive years the economy grew at 3.9 percent after adjusting for inflation. By 1998, the federal budget was in surplus, and the Congressional Budget Office was projecting large federal budget surpluses as far as the eye could see.

By any objective measure, then, supply-side policies worked. And further vindication came just a few months ago when Robert Mundell was awarded the Nobel Prize for economics.

### Where We Are Today

Despite Mundell's Nobel Prize this year, austerity economics retains mastery of the hearts and minds of the American political Establishment. The Congressional Budget Office forecasts $2.895 trillion in budget surpluses during the coming decade. Federal revenues are at an all time high as a share of GDP (21 percent). Yet, this year the Congress could manage to pass only a paltry one-percentage-point tax rate reduction because both political parties are convinced that surpluses are best spent on retiring the national debt.

Federal Reserve Chairman Alan Greenspan also advised Congress against cutting tax rates. The Fed has raised interest rates three times during the past year trying to slow the economy as it fights a phantom inflation. It continues to create confusion and uncertainty in the economy by sending signals almost daily that more interest rate increases are on the way if the stock market keeps rising and the economy does not slow down to its liking. The Fed seems to be intent on reviving the discredited Phillips Curve.

In this space 18 months ago, this author warned that "unless immediate action is taken . . . at least part of the projected surpluses will vanish into thin air before they ever materialize, and any surpluses that do materialize will be wasted." And that is exactly what happened.

This year, they are at it again. Republicans hide behind budgetary gimmicks in order to pretend with a straight face that they are not spending any of the Social Security surplus. President Clinton sanctimoniously indicts Republicans for their budgetary hijacks, accuses them of raiding the Social Security Trust Fund and pretends with a straight face that he wants to protect the Social Security surplus. At the same time, he proposes a huge new prescription-drugs entitlement for senior citizens.

In their fervor to eliminate the national debt, Washington elites seem to have lost all appreciation of the beneficial uses of debt, *and the Establishments of both political parties ignore* ***economic growth*** *as the fundamental prerequisite for everything else government might hope to achieve.*

As illustrated by the IMF's ill-fated efforts to impose austerity on the developing nations of the world, austerity is a destructive policy. Far from producing prosperity and stability, austerity creates economic misery and is politically, socially and economically poisonous. *That is why a debt-retirement economic strategy is ill conceived, ill advised and counterproductive under current circumstances.*

The current tax code is counterproductive and it inhibits the industry and genius of the American people. Every day that this tax code remains in place, it is harming the economy far more than any beneficial results one conceivably could hope to achieve through debt retirement.

In 1981, George Gilder articulated a supply-side precept that today's political Establishment would do well to learn: "In an expanding economy money available now for investment is many times more valuable than money paid later in interest . . . To the enterprising capitalist the future always promises more abundance than today. Only in a static, uncreative economy does it pay to pay as you go."

It is time to return to the Prized and proven supply-side policies of Robert Mundell; stop obsessing on the debt burden (which declines automatically with economic growth); repudiate the Paygo rules (which stand as a monument to that obsession); and cut tax rates across the board to maintain healthy and robust, investment-driven, non-inflationary economic growth. And to the Fed, we should send a Christmas Card with the following inscription from an address delivered by Ronald Reagan at the University of South Carolina in 1983: "There are no such things as limits to growth, because there are no limits on the human capacity for intelligence, imagination and wonder."

Dr. Lawrence A. Hunter is Chief Economist at Empower America

# Saving Our Environment FROM Regulations

## A Closer Look at Two of The Worst Federal Regulations For This Year.

One of the most damaging trends in recent years is the degree to which the federal government has attempted to regulate the lives of U.S. citizens. Ronald Reagan once quipped, "Government exists to protect us from each other. We can't afford the government it would take to protect us from ourselves." But unfortunately, the federal bureaucracy has attempted to take on that responsibility, as well. The result has been the proliferation of federal regulations over the past century, and damage to personal freedom and to the economy.

Granted, some of the regulations initiated over the years have saved lives and enhanced safety. But the incessant multiplication of inane regulations continues at a staggering pace. Each year IPI publishes a report surveying ten of the worst federal regulations, featuring regulations worthy of the honor. This year's selections are no exception. Due to space limitations in this newsletter, only two of those regulations will be featured, but for a complete copy of the 1999 edition entitled *Big Government And Bad Science: Ten Case Studies in Regulatory Abuse* visit our website, at www.ipi.org.

### Dreaded Hypoxia

By Congressional order, the executive branch must devise a plan for mitigating hypoxia in the Gulf of Mexico by May 30, 2000. Although it sounds like the name of some dreaded disease, “hypoxia” is the technical name for “a low-oxygen zone in which fish cannot live”. But before you breathe a sigh of relief that it isn’t another disease, understand how the federal government’s involvement in hypoxia could make the U.S. economy very sick.

Congress mandated the rescue of the Gulf from hypoxia. As the theory goes, farmers are applying too much fertilizer, which is running off into the waters of the Mississippi River system. The runoff has apparently caused a huge and expanding “dead zone” (hypoxia) in the Gulf of Mexico, threatening to destroy the Gulf, its fish, and its fishing communities.

It took many agencies and special interest groups to come up with a solution to the hypoxia problem. Two proposed solutions are already on record: (1) Cut back the use of fertilizer on the Midwest farms by 20 percent; and(2) Convert 24 million acres of current farmland into new wetlands and forests.

Now, those may sound like reasonable solutions to the hypoxia problem. And they might be, *if* there were a hypoxia problem. The truth is that the “dead zone” is likely a natural phenomenon connected to rainfall patterns in the Mississippi Valley, not fertilizer usage. Thus, in the drought year of 1988, the hypoxic zone essentially disappeared, but after the huge Midwest floods of 1993, the zone doubled in size, and is now returning to its normal size. Furthermore, the rich marine life of the Gulf depends on the nutrients which come down the Mississippi. The Louisiana Department of Fisheries has warned for years that reducing the nitrogen in the river may starve the Gulf fishery.

In fact, the White House Task Force says it can find no economic or ecological damage from the current nutrient flows. Imagine the regulatory embarrassment—no problem can be found. Undaunted by the facts, the hypoxia team wants to impose its agenda anyway, with potentially grave economic consequences to the Gulf fishing communities and Midwest farmers—and ultimately the consumers’ pocketbook.

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Dennis Avery is Director of Global Food Issues at the Hudson Institute

### Shoot, Shovel and Shut Up

Just over a quarter of a century ago, President Nixon signed into law the Endangered Species Act (ESA) of 1973. With the stroke of a pen, he created what is arguably the most powerful and far-reaching law in the nation’s history: A law said to trump all other laws in according priority to endangered species over all other national concerns; a law greeted enthusiastically by Congress and the environmental community as “the nation’s principal tool for protecting species from extinction.”

But 25 years later, the ESA is mired in controversy and seven years overdue for reauthorization in a Congress that can find no way of fixing this tragically flawed and broken law. The controversy is due in part to the fact that in 25 years, not one single species has recovered because of ESA intervention. The intention of the Act is to list imperiled species, assist them in recovering, and then “delist” them. Of some 1,400 “protected” species, a mere 27 have been delisted. According to the U.S. Fish and Wildlife Service, which administers and enforces the Act, of those 27, seven went extinct, seventeen were data errors, and three rallied without the Act’s help. Included in that group you will find the national symbol—the Bald Eagle.

Although touted by the current administration as a demonstration of the merits of the Act, the Bald Eagle’s recovery is not linked to the ESA. In reality, the 1972 ban on DDT is what eliminated the major cause of the eagle’s reproductive failure. Likewise, the subsequent restoration of the eagle population in almost entirely attributable to techniques developed by the private Peregrine Fund.

Why, despite billions of dollars, has the ESA failed so miserably? It has failed because it has been used not to protect endangered species, but as a cover for cost-free, land-use control. By threatening landowners with the uncompensated loss of their land or crops, the ESA encourages the removal of wildlife habitat. The lesson the ESA teaches is: the better steward a landowner is, and the more wildlife habitat he maintains on his land—the more likely he will be punished by losing the use of his land.

> **“We can’t afford the government it would take to protect us from ourselves.”**
> Ronald Reagan

By threatening landowners who make room for nature with the uncompensated loss of their land or crops, the ESA unwittingly encourages landowners to get rid of wildlife habitat and sterilize their property. This is known as the “shoot, shovel and shut up” syndrome. The name is descriptive and self-explanatory.

If Congress were truly committed to the stated goals of the ESA, it would begin to work *with* habitat landowners instead of against them. The Endangered Species Act needs to be repealed or amended so that the existing compulsory regulations are replaced by voluntary, non-regulatory incentives. Paradoxical as it may seem, a non-regulatory law would be the only act to actually protect endangered species without busting the budget or requiring vast new sources of funding.

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R.J. Smith is Senior Environmental scholar at the Competitive Enterprise Institute

# Starting Down the Long Road of Education Reform

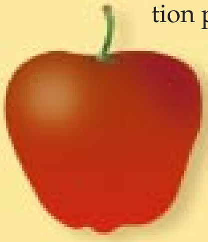
How has the quality of our children's education gone from something we took for granted in the middle of the century to (according to many polls) the number one concern and priority of the majority of Americans today? A recent Gallup poll reports that our confidence in the public school system is continuing to decline. We are clearly at an education crossroad. What should be done? Which road should be taken to improve the quality of public education in the future?

The road toward education reform is already littered with failed educational experiments such as the open classroom teaching format, whole language reading programs and the pass/fail grading systems. Today, small local, neighborhood schools have been replaced with mega-campuses, complete with management centralization and remote supervision. Not so many years ago, a hug from the teacher provided all the security a gradeschooler needed. Now, even metal detectors and on-campus officers can't deter the fears of students.

The fate of education in the future will, in large part, be determined by legislation initiatives enacted by Congress this year and next. *The Washington Post* recently reported that education funding "is likely to become a hot-button issue in next year's elections." But the debate is already heating up since the administration and Congress are philosophically far apart on the funding issues. Sen. Judd Gregg (R-NH) sums up this philosophical standoff with his comments, "This isn't about education, this is about power, it's about controlling dollars for the sake of power."

And there are a lot of dollars to be controlled. For instance, about $130 billion in federal funds has been channeled into public schools over the last three decades under the Title I program alone. Title I is the government's program intended to aid students who are poor, disabled or have limited English proficiency. This entitlement program has become a crucial funding source for many school systems, especially in large cities. For example, the Los Angeles Independent School District will receive almost $200 million in Title I funds to add to its budget next year. Statewide, California received about $830 million in the last fiscal year, 11% of the total $7.3 billion Title I budget.

A bill recently passed by the House of Representatives raises next year's authorized funding to $9.9 billion. Although this bill falls short of the goals of education reformers, it does take some initial steps toward greater accountability for the massive federal funds being poured into the school systems. One victory achieved by education reformers was passage of a separate bill enabling 10 states to participate in a pilot program giving them more freedom in complying with Title I and other federal school programs.



Regardless of the political spin given this education plan, or the final version approved by the President, it is undisputed that education reform *is* and will be on the minds of the politicians and the voters in the upcoming election year. Although no one can predict where this road will lead, the opportunity for reform is most certainly moving forward. IPI

# IMPACT

## IPI Touts Importance of Small Business at Senate Press Conference

*IPI President Tom Giovanetti looks on as Majority Leader Dick Armey praises the IPI study "Barriers to Entrepreneurship" at IPI's Capitol Hill press conference.*

The economic impact of America's small businesses was the focus of a press conference in the Mansfield Room of the U.S. Senate this summer, where IPI released its study, "Barriers to Entrepreneurship."

House Majority Leader Dick Armey and Senate Small Business Committee Chairman Christopher "Kit" Bond both called the movement to relieve small businesses of some of their tax and regulatory burdens vital to the interest not only of the businesses, but to America's workers and the health of our economy.

The IPI study, by Naomi Lopez, a research associate with IPI and director of the Center for Enterprise and Opportunity at the Pacific Research Institute, shows that although small and medium-sized businesses account for almost all net new jobs, tax and regulatory burdens on these firms is nearly double that of large companies.

Also joining Ms. Lopez in identifying the problems facing small business owners and suggesting policy solutions was Angela Antonelli, Director of the Roe Institute for Economic Policy Studies at The Heritage Foundation. IPI

*IPI Research Associate Naomi Lopez discloses how taxes and regulations are impeding new business formation.*


## IPI's New Internet Project

This year, the Institute for Policy Innovation has committed to making high-tech and Internet issues an important part of our policy program. IPI will be working to explain to policy makers and the American people how critical the high-tech sector is to the health of our economy, and will explain how issues such as taxes and regulation are key to keeping this industry sector as productive as possible.

As part of that program, IPI is a founding member of the e-Freedom Coalition, a group of non-profit and activist organizations dedicated to keeping the Internet and e-commerce free of burdensome taxes, fees and regulations. IPI is the registered owner of the domain e-freedom.org, and IPI created and maintains the website www.e-freedom.org.

e-freedom.org will be the nexus of the battle against Internet taxes, access fees, regulation against free speech and encryption, and all other attempts by Big Government to control the incredible medium of the Internet. The website contains publications, press releases, op/eds, and links to other resources on the web.

*We invite you to check out the website, and become a part of this critical fight to keep the Internet free.* IPI


## Parting Shots of the Century

"We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions…With those taxes in there, no damn politician can ever scrap my social security program."

**President Roosevelt**, *as quoted by historian Arthur Schelsinger Jr.*

"Because it has become increasingly difficult for individuals to build their own security single-handed, Government must now step in and help them lay the foundation stones, just as Government in the past has helped lay the foundation of business and industry."

**President Roosevelt**

The Great Society rests on abundance and liberty for all. [It]is a place where every child can find knowledge to enrich his mind and to enlarge his talents."

**President Johnson, 1964**

Every worker, every citizen must be made to understand that Social Security is financially sound; that it can and will do what is expected when the time comes, whether that time be tomorrow or another 50 years from now."

*Former Commissioner of Social Security,* **James Cardwell,** *1985.*

"We can lecture our children about extravagance until we run out of voice and breath. Or we can cut their extravagance by simply reducing their allowance."

**President Reagan**, *justifying a reduction in the federal government.*

"Teachers are asking me how they can fulfill their responsibilities of teaching young people the moral, ethical and spiritual values required in a free society while the President of the U.S. disregards the nation's traditionally high standards of morality."

**Helen Wise,** *National Education Association (NEA) president, in a letter to Nixon, 1973.*

## IPI Insights



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