Rehabilitating the Supply Side

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It's been a good ten years since most people have taken seriously that quintessential Reagan-era concept, 'supply-side economics.' In case you forgot, supply-siders are the group of economists and pundits who argued that the one true way to create a high-growth economy is to lower taxes. They argued for lowering marginal tax rates (the rate on the last dollar of income) because doing so increases people's incentive to work. Economist Arthur Laffer drew his famous curve showing that if marginal tax rates were raised high enough, the government's tax revenues actually fell; Jude Wanniski wrote The Way the World Works, an immodestly titled treatise that correlated the rise and fall of civilizations with the fall and rise of marginal rates.

That theory won adherents in the 1980s, thanks to the fact that, for a while anyway, it did indeed seem to be the way the world worked. After all, the fall in marginal rates under Ronald Reagan, from a top rate of 70% to 50% in 1982 and then to 28% by 1988, helped create and sustain the seven-year economic boom in the 1980s.

Nowadays, though, supply-side theory has lost most of its respectability, mainly because we are six years into a boom that easily survived the Clinton tax hike, which took the top marginal rate from 31% to 39.6%. Deputy Treasury Secretary Lawrence Summers crows that the supply-siders were all wrong. But the problem here is not that the supply-siders' underlying theory is incorrect--rather, it's that its adherents applied it poorly back in 1993 when Clinton was getting ready to raise taxes. If you look beyond that one wrong call, however, supply side looks rather smart.

The supply-side downfall began with a flurry of articles five years ago denouncing the Clinton tax hike in terms that seem awfully Chicken Little-ish today. During the tax bill debate, for instance, a supply-sider at the Cato Institute named Stephen Moore wrote that Democrats about to vote on the tax-increase bill would have to choose between 'torpedoing their President and torpedoing the economy.'

Things didn't work out that way, a fact that has been taken as a wholesale refutation of supply-side theory. But the reason Clinton's tax increases didn't have dire consequences is simply that they weren't that big. The highest-income taxpayers can now keep 60.4 cents on the dollar, vs. 69 cents before the Clinton increases, making for a 13% reduction in work incentives. Compare that with the 67% increase in work incentives when Reagan cut the top rate from 70% to 50%.

Another reason the supply-siders went wrong is that, ironically, they failed to acknowledge two important factors on the U.S. economy's supply side--factors that helped maintain growth despite the tax increases. First, improvements in information technology have greatly increased productivity. Second, federal government spending decreased dramatically, which freed up a huge amount of resources for private use. Between 1992 and 1998, government spending fell from 22.5% of GDP to under 20%. This translates into about $200 billion a year kept by the citizens rather than the government.

While the supply-siders have received ample vilification for being wrong about the Clinton tax hikes, they've received scant credit for being right about another key economic issue: the role of monetary policy in controlling inflation. When Reagan allowed a huge deficit in the early 1980s, Keynesians Lawrence Summers and Paul Krugman (a FORTUNE columnist) argued that inflation would go sky-high. Supply-siders argued instead that monetary policy was the key to controlling inflation. As long as the Federal Reserve didn't pump up the money supply too much, they claimed, inflation would fall. The supply-siders were right. The Fed chopped inflation from 13.3% in 1979 to 4.4% in 1987 to about 2% now. Today central bankers in New Zealand, Canada, and around the world make low inflation the No. 1 goal of monetary policy.

When it comes to tax policy, the world's governments seem more receptive to supply-siderism than our own. After Reagan and Margaret Thatcher cut top marginal tax rates, most rich countries imitated them. Sweden cut its top rate from 80% to 56%, France from 65% to 52%, and Japan from 65% to 50%. The governments of those countries worry about losing capital and some high-income workers in the global tax competition. Moore predicts that 'the top marginal tax rate in the U.S. will fall to under 35% within ten years, due mainly to global competition for capital.'

So supply-siders screwed up and made one really bad call. But all over the world, monetary policy has tamed inflation, and governments are cutting marginal tax rates. Maybe supply side really is the way the world works.