The GOP Could Reform Its Way To Keynesianism

By Brian Domitrovic
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"Supply-side economics needs a 21st-century update," went a post at the American Enterprise Institute's blog the other day, challenging the assurance from the Cato Institute's Dan Mitchell that no, it doesn't. The point of contention in the rising, intra-Republican squabble over economic policy is whether it is best to solve the problem of the tax code through comprehensive rate cuts, or through credits for middle class families.

In the latter camp, Sen. Mike Lee of Utah and the contributors to the volume *Room to Grow* are suggesting a modest cut in rates, such that the income tax would have two levels, one for low to median income, at 15%, and another for high income, at 35%. (The bottom rate today is 10% and the top rate 39.6%, with five further ones in between.) In the former camp are the residual supply-siders of classical Reagan tinge, still including Rep. Paul Ryan, who emphasize rate cuts and the devaluation of all exemptions and loopholes that rate cuts automatically accomplish.

The argument of the *Room to Grow* contingent is that Reagan's tax cut made sense in 1981, when the marginal rate was 70%. Today, with working people hurting so, more credits for having children and expanding a family should be the preferred Republican option. As it is even now, taxpayers of regular means get $1000 deducted from their taxes for every child at home.

The first thing that must be clarified about this square-off is that the Mike Lee/*Room to Grow* project has nothing to do with supply-side economics. Supply-siders from start to finish, from Robert L. Bartley to Jack Kemp to Jeff Bell (now putting the heat on Cory Booker in New Jersey), have always been opposed to tax expenditures/loopholes/preferences, whatever you want to call the innumerable carve-outs in the tax code.

Every one of the great supply-side tax cuts of the 20th century had the salient characteristic of striving to undermine tax preferences by making them less valuable.

One of the express objects of Andrew Mellon's marginal rate cuts of the 1920s was getting John D. Rockefeller out of $42 million in tax-exempt municipal bonds by taking the marginal rate from 77% to 25% (success was achieved). John F. Kennedy's rate cuts

were devised in a Treasury department at war with loopholes that counted among its assistant secretaries Stanley Surrey, the man who coined the derisive term "tax expenditures." And as Bartley (the *Wall Street Journal* editor) said of the Reagan era in 1992, when you cut rates, "you don't have to launch a search-and-destroy mission for loopholes; they will dry up in any event."

Jack Kemp was always ready to point out why tax preferences are particularly harmful when directed at lower earners. These things raise their marginal tax rates. Today, a family with children making just over $110,000 pays a marginal tax rate five points higher than the statutory rate of 25%. This is because the $1000 credit for having kids phases out at this level of income. Tax preferences for the average earner, Kemp always warned, get people stuck in their current economic class and dampen private initiative to take advantage of opportunities, locking up human capital.

As for contemporary relevance, Casey Mulligan has been showing us how Obamacare is jacking up effective marginal tax rates on those with lower incomes, in some cases taking them to 100%. If somehow you clear the Obamacare hurdle and reach median family income, and *Room to Grow* gets its way, there will be another round of higher effective rates waiting for any further increases in income. You can forget about ever improving your station.

Then there is the matter of the fiscal-monetary policy mix. Here again, the tax-preference idea remains alien to supply-side economics. As Robert Mundell made clear in his canonical definition of supply-side economics in 1971, "The correct policy mix is based on fiscal ease…, in combination with monetary restraint….The increased momentum of the economy provided by the tax cut will cause sufficient demand for credit to permit real monetary expansion at higher interest rates."

The Federal Reserve has been shoving money into bondholders' hands for years now, to no good effect. It has been "pushing on a string." Tax cuts at the margin have all along been the missing element. Such tax cuts increase the real return of all work and enterprise and thus increase real monetary demand. Increases in real monetary demand justify Fed expansionism and permit the dollar-masters to watch more important things, such as the dollar price of gold, oil, foreign exchange, and commodities.

Tax cuts at the margin—and only at the margin, in that these correspond to new economic initiative—hold the key to making monetary policy effective. Tax preferences not only do nothing in this regard; in necessitating higher marginal rates on account of their revenue losses, they undercut this essential supply-side purpose.

People say that the world is different today—Reagan had to deal with a marginal rate at 70%, while ours is only around 40%. This is to misunderstand what Reagan did and did not accomplish. Tax cuts and tax reform were accomplished in the 1980s: their legacy should be consolidated and extended, not repudiated.

Not accomplished was any kind of formal reform of the monetary system. No reconstituted gold standard, no price rule, no nothing outside of the same old seat-of-

the-pants Fed chair/Board of Governors best guess at monetary policy was the practice institutionalized in the 1980s. But then again monetary policy was easy in the 1980s. Marginal tax cuts produced phenomenal demand for the dollar.

The *Room to Grow* suggestion is Keynesianism by another name: non-marginal rate cuts so that people closer to the bottom can have more to spend. It is odd to hear that supply-side economics should be updated because it succeeded in the 1980s. The proposed update suggests a return to demand-side economics, whose record includes having failed spectacularly in the stagflation of the 1970s.