RAHN: An inconvenient economic history

Record shows recovery results from tax cuts, not government spending

Where is the historical evidence to show that big increases in government spending as a percentage of gross domestic product (GDP) lead to faster economic growth and more job creation? Answer: There isn't any.

Last week, I inserted a table in my column that showed that the first four quarters after the bottom of the recession in 1982 resulted in an average quarterly growth rate of 7.8 percent versus an average quarterly growth rate of just 3.2 percent in the first four quarters after the bottom of the 2009 recession. In addition, I had noted that unemployment fell sharply - 2 percent under the Reagan tax-rate-cut solution in 1982-83 versus no drop under President Obama's greatly increased government spending "solution" - in the first four quarters of the recovery from the bottom of each recession. Tax rate cuts trump government spending increases.

The column upset some of those who want even more spending, such as New York Times columnist Paul Krugman, who made this silly rebuttal: "When Paul Volcker [in 1982] believed that we had suffered enough, he cut [interest] rates, housing sprang back - and it was housing that mainly drove the recovery. Reaganomics was basically irrelevant." Hmmm, sounds like Mr. Krugman is arguing that cutting tax rates on capital gains, interest, dividends and other income had no effect on the cost, ability and benefit of buying a home. He also fails to note that virtually every other sector, in addition to housing, sprang back after the Reagan tax cuts went into effect. What Mr. Krugman and the other critics have been unable to provide are historical examples of when big increases in government spending led to higher growth and more job creation. (The big spending by Presidents Hoover and Franklin D. Roosevelt just prolonged the Great Depression.)

Ezra Klein, who blogs for The Washington Post and Newsweek, as well as others attacked my Cato colleague, tax economist Dan Mitchell, for writing in support of my column. Mr. Klein and other critics argued that all recessions are different, and hence comparisons are unfair. It is true that each recession is a bit different, and there are many variables that affect economic performance, such as monetary policy, the world economy, etc., but that does not mean we can draw no inferences about the effects of alternative policies. Mr. Klein also argued: "If you want to compare Reagan to someone, you should look at [Bill] Clinton, who also entered office amidst a traditional recession." Mr. Klein and other critics have forgotten, if they even ever knew, their economic history - the fact is that the U.S. economy had been growing for two straight years when Mr. Clinton took office in January 1993. The mild 1990 recession was well behind us.

Over the past 30 years, several alternative economic policies have been tried, and so it is useful to take a look at what happened, which is summarized in the accompanying chart.

President Reagan had inherited a stagnant, high-inflation economy. His solution was monetary restraint (implemented by Paul Volcker at the Fed), tax-rate reduction and regulatory and spending restraint (Reaganomics). He did not have control of Congress, so his tax-rate reductions were not fully phased in until 1984. The result was seven years of high growth and falling unemployment, inflation and deficits.

President George H.W. Bush ran for office on a no-new-taxes pledge and an inflation-adjusted spending freeze. Unfortunately, within months of taking office, he abandoned the program he ran on, allowing both spending and taxes to increase. Mistakes by the Fed led to a mild recession, and the Bush tax and spending increases led to a slow recovery. President Clinton was elected in 1992 with a pledge not to increase taxes, on which he promptly reneged, but he did restrain the growth in spending, and economic growth did pick up. By 1996, the Republicans were in control of Congress, and they and the Clinton administration sharply restrained spending growth and cut the capital gains tax rate in 1997. The result was robust economic growth, low unemployment and a few years of budget surplus.

Economic growth faltered in 2000 because of an overreaction by the Fed to the dot-com bubble and the Y2K problem. The economy already was in recession when George W. Bush took office in the first quarter of 2001. The initial administration response was to grant tax rebates and credits, which, as the supply-siders correctly predicted, would do little to revive the economy. Finally, the George W. Bush administration cut marginal tax rates in 2003 but allowed government to grow as percentage of GDP, particularly after the Democrats took control of Congress in 2006.

President Obama and the Democrat-controlled Congress have massively increased government spending as a response to the recession, which has given us deficits twice the size of those experienced under President Reagan, very slow growth, a declining labor force and high unemployment. History shows that tax-rate reductions and reduced government spending as a percentage of GDP are associated with high growth and job creation. One can go back 100 years, and there is no data to support the argument that bigger government leads to prosperity.

It is policies that matter, not party. The historical record indicates that if the country adopted the spending levels (as percentage of GDP) of the second Clinton administration and the tax rates of the second Reagan administration, the economy would boom and the deficits would largely disappear.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.