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Economics and Why Election 2000 Is Important

This essay was originally published in Muhlenkamp Memorandum Issue 56, October 2000. This essay is the capstone of Ron's writings on economics. It weaves together his theories on inflation and its effects on the bond and stock markets, interest rates and what drives them, taxation and work incentive, and government spending. The common thread is the idea that people drive the economy. The government influences that relationship. Therefore, when we make political choices, we are also making economic choices. This essay explains the effects of those choices. Read it again and again—at least every election year.

In the past 35 years I have witnessed a fascinating experiment in economics. In the mid-1960s, when I was in college, the U.S. Gross Domestic Product (GDP) was growing at 4%–5%, mortgage rates were at 5½%, and the unemployment rate was at 4%–4½%. Inflation wasn't even mentioned because it had been at less than 1½% since the wars (WW II and Korea). All of this was considered "normal."

The economics books I studied at the time discussed inflation in terms of "cost push" and "demand pull," with the underlying theme that inflation was caused by too much growth in the economy. The books also argued that government spending was at least as stimulative as private spending and was actually more effective at jump-starting an economy. As a capstone to all of this, I was taught that with the U.S. economy growing at 4% per year and the Soviet economy growing at 6% per year, GDP per capita in Russia would surpass GDP per capita in the United States in roughly the year 2000.

By 1968, the U.S. economy was enjoying its second-longest expansion ever. Consumer confidence was high, and Wall Street was booming. Stocks like Litton Industries, LTV, National Student Marketing, and Equity Funding were making investors millionaires almost overnight. A book, The New Breed on Wall Street, featured the "hot" mutual fund managers of the day including Fred Mates, Fred Alger, and Fred Carr.

Economists were so confident of their ability to "fine tune" the economy that some university economic departments cancelled their courses on the business cycle. The point is—we've been here before, but we blew it.

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Just eleven years later, in 1979, inflation was 10%, GDP growth was 2%, unemployment was 10%, and mortgage rates were 11% on their way to 15%. President Carter complained about a malaise in the American public.

What Happened?

In the mid-1960s President Johnson wanted to fight the war in Vietnam and the war on poverty at the same time, but he didn't want to raise taxes to pay for them. In order to finance the spending, the U.S. Treasury and the Federal Reserve expanded the money supply at a rapid rate (they printed excess money). As is usual, the early effects were beneficial; the negative effects took a little longer (sort of like using a credit card—the payments are delayed). Gradually, as we kept printing more dollars, the value of those dollars fell. By 1973 the value of the dollar (relative to its 1965 value) had fallen 31%. Compared to other benchmarks, it had fallen 33% vs. the Deutschmark, 22% vs. the Japanese yen, and 67% vs. gold. All this time we were buying ever-larger quantities of oil from the OPEC nations and were paying for it in ever-depreciating dollars. So, in 1973, OPEC raised the price of oil. This gave our politicians a scapegoat for inflation, but the politicians didn't change their policies. Why should they? Popular economic theory, which I was taught at the time, held that inflation was caused by supply and demand constraints, not by printing money.

By 1979, the dollar (relative to its 1965 value) had fallen 59%. It had fallen 57% versus the Deutschmark, 44% versus the Japanese yen, and 88% versus gold. The dollar was so weak that President Carter deemed it necessary to appoint an "independent" central banker as chairman of the Federal Reserve Bank. In order to rebuild confidence, President Carter had to choose someone whom our trading partners would trust to support the value of the dollar as his first priority. He chose Paul Volcker.

Also in 1979, I wrote an essay, "Why the Market Went Down," to explain the impact of inflation on the stock and bond markets. Based on this paper, we told our clients in 1980 that if Reagan and Volcker were successful in getting inflation under control, we'd have a good decade in the stock and bond markets.

Paul Volcker soon made it clear that he planned to grow the money supply at a 6%–8% rate, and economic commentary hit the fan. The economic community argued as follows: "Inflation is 10% and is intractable. If you only grow the money supply at 6%, the economy will be forced to shrink at a 4% rate (6–10 = –4)." Volcker did it anyway, and by 1982 inflation fell to 4% with GDP growth of 2%.

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Volcker's action and the ensuing economic numbers demonstrated that inflation is caused by printing too much money, not by too much growth. He also demonstrated that GDP growth competes with inflation for money and that GDP growth can outmuscle inflation for the available money supply. Inflation was not intractable. In fact, for a given growth in the money supply, higher growth in GDP actually causes lower inflation!

While we still have some economists and a lot of commentators believing that growth causes inflation, central banks have learned the lesson. As evidence of this, I'll cite the central banks of Europe. When their governments decided to adopt a single currency, the euro, it was necessary to bring the inflation rates in several countries down to the level of Germany. They didn't even attempt supply/demand management. Each country set out to lower its inflation rate by controlling the growth in its money supply, and each was successful in lowering its inflation rate.

Today inflation is under control in each of the major countries and each of the major currencies of the world. Inflation is coming under control in a list of countries from Brazil to Chile to Greece, and the sensitivity to inflation of investors in the stock and bond markets gives me confidence that it will remain under control for the foreseeable future. We've learned the lesson that Paul Volcker taught us.

But the second lesson of the past 35 years, the lesson of Ronald Reagan, we haven't learned.

In 1960, real economic growth had slowed from the 4%–5% rate of the 1950s. President Kennedy was advised by some economists to increase government spending to jump-start the economy. He was advised by a few others to cut taxes to jump-start the economy. He did both, choosing to go to the moon and to cut taxes. The economy resumed 4%–5% annual growth.

As we said earlier, President Johnson simultaneously fought the Vietnam War and the war on poverty. He sought to pay for them by inflating the money supply. The first effect of this inflation was a decline in the value of the dollar, but another effect was on income tax rates.

In the United States, we have progressive income tax rates. The tax rate progresses higher, as your income progresses higher. So as your income increases, your taxes increase faster. In the 1970s, these rates were not indexed for inflation. In fact, in the 1970s, if your income went up 10%, your federal income taxes went up 20%; in other words, a worker who got a raise equal to inflation pretax was still losing ground after tax. It also meant that professional people got bumped into ever-higher tax brackets, the highest being 70%.

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At a 70% rate, individuals gain more by avoiding taxes than they do by producing more income. Many people resorted to "tax shelters," which were designed to take advantage of provisions in the tax law rather than produce useful or desired goods and services.

With the average wage earner falling behind and the top wage earners discouraged from producing more, or from hiring others to produce more, is it any wonder that we had a malaise in the economy?

Ronald Reagan changed all that. He cut the top income tax rate to 28%. Tax shelters went away, and the top earners went back to producing useful goods and services and hiring others to help them. But when Reagan announced his tax cuts, economic commentary hit the fan. Many economists maintained that his tax cuts would cause federal deficits, which would cause government borrowing and rising interest rates. Rising interest rates would crowd out private borrowing and shut down the economy.

They were right on the first part. Government deficits ballooned. But they were dead wrong about interest rates and the economy. Interest rates fell and the economy boomed.

In June 1991, at an M.I.T. reunion, I had a long discussion/argument with an old classmate who graduated in economics and was, and is, the chief economist at a major consulting firm. He argued that the government deficits would drive interest rates higher. I argued that people's response to rates (by not buying ever larger houses with ever larger mortgages) would drive rates lower.

Long-term Treasury rates at the time were 9%. By late 1993 (two and a half years later), they had fallen to 6%. In late 1993, we concluded that the bond rally was over.

The best explanation I've found for "The Reagan Lesson" came from a friend of mine, a professor of economics at Duquesne University. In 1980, he shared with me the five-day workweek analogy (which was described in the "Prosperity" essay). The analogy culminated in this question: "If on Friday you had to pay 50% taxes on your earnings, would you come to work?" Most people say "no." Clearly, you can tax away work incentive.

Here's a real-life example. At one time, I tried to teach my teenage daughters about saving money by insisting they save 50% of their earnings. (I thought they were spending frivolously.) But the next time I asked them to work, they refused. It seems they had a lesson for me. I learned that what I thought was "frivolous" spending was, in fact, their incentive for working. Think of it this way. What encourages you to work overtime and produce more? Is it basic food, clothing, and shelter; is it discretionary goods like a better car, a better house, or a better vacation; or is it so you can pay more taxes and the government can spend more money? In Japan, for 10 years the government has tried to jump-start the economy by

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building more roads and bridges. The strategy is straight out of my economics book from the 1960s. It hasn't worked. It's why I believe Japan needs a "Ronald Reagan."

Ronald Reagan understood the economic incentives of tax rates. He understood that if you lower the tax burden, people will produce more, the economy will expand, and over time, tax receipts will also expand. George H. W. Bush did not understand this, and he allowed conventional economic arguments to convince him to break his pledge and raise taxes. President Clinton doesn't understand it, which is why he could make the statement, "We could cut taxes, but you might not spend it right." I didn't think my daughters were "spending it right," but I learned that there is no "wrong" spending in the private economy, because that spending is the incentive for more production.

Reagan's tax cuts did create a deficit, but deficits per se are not the problem. The question is what you use the money to accomplish. Personally, I've used deficit spending in 17 of the past 38 years: six years when I was in college, eight years when my kids were in college, and three years when we bought houses. Each worked out well. I have not borrowed money to take a vacation or buy a new car, nor to buy things that depreciate. Ronald Reagan borrowed money to get the economy moving again and to win the Cold War. Both worked very well.

Today we're hearing the same arguments against tax cuts that we heard in 1980. Politicians believe they can spend our money more wisely than we can. That is no surprise. What's surprising is how many economists still believe this after the evidence of the last 20 years.

But the pertinent question is not who can spend the money more wisely. The pertinent question is which spending results in the greater incentives for more production and thus more prosperity for ourselves, our kids, and our grandkids? With the top income-tax rates (including state income taxes) at 40%–50% we are once again at risk of killing the incentive for economic growth.

We need only to look at estate taxes to see the result. Estate tax rates are at 37%–55%. And today we're seeing schemes for avoiding estate taxes that rival the tax shelters of the 1970s in complexity and nonproductivity.

To me, elections are not about Democrats versus Republicans. Elections are about politicians versus taxpayers and consumers. Elections are about choosing bigger government versus choosing smaller government.

I'm amazed at the number of intelligent people who tell me they're not likely to vote because they "can't get excited about either candidate." Folks, it's only the free market that offers you 15 choices of cereal or toothpaste so you can get exactly what you want. Government is different from the free market

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because it insists upon only one solution for all people. In the upcoming election, our choices are down to two. We will have a president, and he will have an agenda. If we don't choose the better agenda, we will have to live with the other one.

2007 Addendum: Expanding on the Five-Day Workweek Analogy

Let's take our five-day workweek analogy one step further. Remember that most people said they would not work at a 50% tax rate. Well, here's a new proposition:

Pick a person whose name you know, a friend or a stranger. For the next 20 years you will be a partner of that person in a one-way partnership. You have your choice of two sets of terms, as follows:

A. You will receive 30% of everything that person earns over $30,000 per year.

B. You will receive 30% of everything that person earns from $30,000 to $100,000 per year; and 70% of everything he/she earns over $100,000 per year.

Which do you choose? A or B?

It's easy to see why many people might choose B, expecting to get more money. But remember what we saw in our five-day workweek analogy: people say they won't work at a 50% tax rate, so they certainly won't work at a 70% rate. And to your "partner," the proposed one-way partnership looks like a 70% tax rate. So if people do what they say they'll do, at the 70% rate you will receive 70% of nothing. And 70% of nothing will always be less than 30% of something.

President Reagan faced the above choice in 1981. The existing top tax bracket was 70%. It resulted in people in the top tax bracket taking time off, "investing" in tax shelters, and not expanding their businesses. In short, it resulted in 10% unemployment. President Reagan chose "A"—a top tax bracket of about 30%, and the U.S. economy has led the developed world for 25 years. Japan and Western Europe have not made a similar choice. As a result, their economies have been slow or stagnant for over a decade. Unemployment in Western Europe is over 10% today compared to 5% in the United States.

The key to the "one-way partnership" analogy is perspective. To choose the terms that make you the most money, you must consider the perspective of your partner. Though you are setting the terms, your partner is the one producing the wealth. I find this analogy useful because our tax system is set up

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the same way. The politicians set the terms, but the tax-payer produces the wealth. Some of our politicians would do well to more carefully consider the perspective of the taxpayer.

About a year ago, a U.S. senator said that if he had to choose between a rich man buying a new Mercedes or Congress taxing that man to buy a new school bus, he, the senator, would vote to tax the man to buy the school bus. The senator is assuming that the choice is between the Mercedes and the school bus. But a Mercedes is discretionary. The man could live without it. At a 35% tax rate, a man who wants a $65,000 Mercedes must earn $100,000 and will pay $35,000 in taxes toward the school bus. At a 50% tax rate, he has to earn $130,000 for that same Mercedes. People tell me that at tax rates of 50% or higher they will not work. In other words, instead of earning that $130,000 for the Mercedes, the rich man might just stay home and relax, which means that at a higher tax rate you will get neither the Mercedes nor the school bus. I believe this is what happened in the 1970s, and I believe this is what would happen should we raise taxes much beyond their current levels.

Bottom line, economics is about people and their choices. The easy way to understand economics is to put yourself into someone else's shoes. If you want to grow the economy, consider the perspective of the people who make the economy grow. What are their needs? What are their wants? Under what terms do they have the greatest incentive to work? When you allow people to benefit from their own efforts, the economy grows, creating more prosperity for everyone—worker, business owner, and politician alike.

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