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THE SUPPLY-SIDE REVOLUTION

THE 1970S WERE A DECADE in which one dark day of news followed another, and April 20, 1978, proved no exception. BROKERAGE BLUES: FOR HIGHLY QUALIFIED, WALL STREET JOB MARKET IS INCREASINGLY GLOOMY read a front-page-left headline of the *Wall Street Journal*. The article discussed a “nightmare at Merrill Lynch” as the firm fired analysts because of slow merger activity. The paper’s “What’s News” section led with a report that the economy was shrinking. The “Business Bulletin” column informed readers that electric utilities were having trouble finding customers. The dollar was also losing value. Finally, over on the far right side of the page, the *Journal* chronicled the troubles of Inco, a Canadian concern that mined and traded nickel. Inco was just one of the casualties of the period’s volatile commodities markets.

Inside the paper, however, was another story that signaled the promise of a brighter era. On page A4, the *Journal* reported that a minority-party congressman from Wisconsin named Bill Steiger was close to finding the

19 votes needed for Ways and Means Committee approval of legislation to reduce the capital-gains tax. The effective rate at the time was 49 percent. Steiger argued that a cut would liberate firms and inspire general economic growth. Such activity in turn would ensure that the tax cut could “pay for itself” in terms of federal revenue.

These days, the reasoning behind the law that became known as the Steiger amendment sounds familiar. But at the time, it seemed strange and otherworldly. It came out of the thinking of a small band of professors, writers, and policy people—most so obscure that mainstream thinkers ignored them. Steiger might get his tax cut for political reasons. But few bought his argument that slashing a rich man’s taxes would help the economy overall. And even fewer accepted his assertion that the cut would not empty federal coffers.

Over the next two decades, the obscure group that argued that tax cuts might pay for themselves would emerge as a formidable force on the battlefield of policy, moving from victory to victory. Their first victories would be intellectual: with great effort, they managed to get their ideas heard and even respected. They would also manage—and this proved crucial—to show that their philosophy was not merely efficient, but compassionate. Next, they moved on to win the political victories that resulted in an implementation of their agenda. This in turn reset the trajectory of the U.S. economy, bringing the higher rates of growth that we now take for granted. Recognizing the order and importance of these original victories is crucial to surmounting the policy challenges that confront us today.

The Keynesian Paradigm

The supply-side story starts long ago, well before the 1970s, with the nation after World War II. It was a period dominated by the doctrine of the English economist John Maynard Keynes—to the near exclusion of the work of all other economists. (Or, to qualify, it was the American conception of Keynesian doctrine that ruled, for Keynes himself was too great and flexible a mind to be doctrinaire.) Keynesianism permeated the political debate, too. From the 1960s onward, both big parties embraced it.

Jimmy Carter, a Democrat, found justification for his weak dollar policy in Keynesianism. Richard Nixon opened the 1970s with the statement “We are all Keynesians now.”

The Keynesians talked in aggregates—as opposed to individual by individual. They said that demand in the aggregate would determine economic growth. Government played a key role by managing that demand and “stimulating” it, from time to time, through two interchangeable tools: federal spending and tax cuts. The form of taxation mattered less than the amount that a given tax purportedly would bring in on paper. Thus a change in a tax would be described not by its rate—“a 10 percent rate cut for the income tax,” say—but by the amount in revenue that the change was said to entail: “a \$5 billion tax cut.”

The Keynesians were not entirely indifferent to the question of where rate increases or cuts were applied. If a specific group was to get a tax cut, the theory held, it might as well be lower earners, more likely than the wealthy to spend what they got back. Tax cuts for the wealthy, by contrast, were almost pointless because of “the income effect”—people who have more money tend to spend it less. They waste the cash or leave it in a vault. Or so the argument went.

The Keynesians saw monetary policy as inextricable from spending and tax policy. In a down period, the Federal Reserve must be “accommodative” to ensure that enough money was available to support a fiscal deficit. Loose money and tax cuts could and should work together. Washington could inflate or talk down the currency if necessary to strengthen domestic growth. The foreign sector was not so important.

Central to all these arguments was the work of a New Zealand-born economist, A. W. Phillips—especially his famous “Phillips Curve.” The Phillips Curve thesis held that a trade-off existed between inflation and unemployment. A little more inflation meant less unemployment; a little more unemployment meant less inflation. A corollary of this thesis was that economic growth was treacherous, since it was inherently inflationary. Another assumption was that government must be front and center on the economic stage, busying itself managing both the aggregates and this trade-off on a day-to-day, even hour-to-hour, basis.

Several factors boosted the Keynesians' influence. The first was generational. Most Keynesians were relatively young, and so enjoyed the natural bonus that accrues to youngsters jousting with their fathers' peers. Keynesian theory and the Keynesian lexicon spread across universities only after World War II. This meant that Keynes became the fashionable hero of economists among both the Korean War generation and the baby-boom cohort. Those baby boomers who learned economics at universities learned it from a Keynesian textbook: Paul A. Samuelson's *Economics*. As for the classical economics that had been standard lecture-hall fare, the academy now tagged it with the ultimate pejorative: "pre-war"—in other words, hopelessly out of date.

But the Keynesian authority also had another, moral, basis. The essential message of the Phillips Curve, as we've seen, was that strong economic growth, with its inflationary by-product, was inherently perilous for the rest of the economy. It wasn't too far from that notion to the more general thought that too much growth would be a bad thing.

The idea that growth should be rationed fit in especially well with the sour, ambivalent spirit of the 1970s. The decade, after all, had begun with the runaway success of a manifesto by a group of academics who called themselves "The Club of Rome." The title of the club's book: *The Limits to Growth*. A singer from the period, Don McLean, expressed its prevalent vision of scarcity in a hit song: "I drove my Chevy to the levy but the levy was dry." The "American Pie" was finite. Therefore, one should pay careful attention to distributing it justly.

The Keynesian arguments on federal spending and tax rates also suited the mood. Federal spending, the reasoning went, was "stimulative"; therefore increasing entitlements would also bring growth. The technical argument that tax cuts for the poor were more economically productive than tax cuts for the rich meant that it was not only kind but also wise to focus on lower rates for modest earners and to keep rates on the wealthy high. In other words, a progressive rate structure, in which tax rates rose like stair steps as you went up the earnings scale, was the most efficient rate structure. Keynes himself had been an elitist in the best sense, but now Keynesianism provided the window dressing for class warfare.

A typical sample of Keynesianism came in a 1979 *New York Times* article by the movement's most eloquent spokesman, John Kenneth Galbraith of Harvard. In Galbraith's view, a tax increase on the wealthy was not a bad thing: the "effect would be to moderate expenditure on more expensive automobiles, more costly real estate, fancier dress, more imaginative furniture, more memorable social observances, and other outlays of less than life-supporting urgency."

The Supply-Side Challenge

The Keynesian culture proved so strong that it made even talking about the economy in non-Keynesian terms a challenge. One of the few people who managed to do it over the decades was Milton Friedman, and this only in the face of perpetual professional challenges to his views. Nonetheless, now more challengers began to emerge. One was economist Robert Mundell, who formulated his thoughts as early as the 1960s in papers for the International Monetary Fund. Today, Mundell is best known as the author of the Mundell-Flemming model, for which he received the Nobel Prize in economics in 1999. The model represented a monetary approach to international capital flows and exchange rates. Fiscal policies, Mundell posited, ought to be handled separately. Thus the first big difference from the Keynesians: Mundell unraveled the Keynesian monetary-plus-fiscal program into two separate strands. Indeed, as Mundell noted, there were times when the best line of attack was a tight monetary policy to control inflation and tax cuts to encourage growth.

Others began to meet with Mundell to learn about his ideas and work through them. They included Arthur Laffer, now of Laffer Associates; Jude Wanniski, then of the *Wall Street Journal*; Robert Bartley, co-author of this essay and at the time the *Journal's* editorial page editor; and a few others. In 1974, the group began holding its own little seminars at a Wall Street steakhouse called Michael I. Their central thought was subversive, at least for their era: growth was an unqualified good.

One of the first things the group discussed was Mundell's separation of monetary and fiscal policy—it might be wrong, but it was certainly

interesting. The group also questioned the emphasis placed on groups and macroeconomics. Were not individuals and microeconomics more important? Third, the group decided that it was time to focus on tax rates, which they thought might matter more than theoretical estimates seemed to suggest. A change in the top rate a taxpayer was subjected to might not affect his average tax burden so much. But it *did* affect his desire to work. If the top rate came down, then he might work much more. Especially sensitive, or so the group posited, was the top marginal rate on the personal income tax, the rate that applies to the last dollar a man or woman earns on his or her climb up the progressive staircase.

Next, the group determined, one should no longer assume that a certain rate increase for a certain population would generate a certain revenue stream for Washington's coffers. Again, tax rates affected behavior; sometimes people simply worked less when confronted with higher rates. Conversely, a big cut to a particularly high tax might actually pull in extra revenue as people worked harder; the change in behavior might offset some or all of the cut's spreadsheet "cost." This argument differed from the traditional conservative case for tax cuts, which held that you made them to reduce the size of government.

Launching a sort of "Battle of the Curves," the group rejected the old Phillips Curve and turned instead to Art Laffer's "Laffer Curve," which looked like a McDonald's arch lying on its side. The Laffer Curve has been denigrated over the years, but it essentially illustrates an instinctive concept: the tipping point. People respond to incentives and disincentives, Laffer held. A tipping point exists beyond which they will work less instead of more. Therefore, a point exists on the tax-rate schedule beyond which higher rates generate less revenue, not more. You would get zero tax revenues with the tax rate at zero; but you would also get zero revenues if the tax rate rose to 100 percent—people would not work.

Finally, the group maintained, one needed to consider all these ideas in the light of exchange-rate regimes and foreign flows of goods and capital. America did not operate in a vacuum; the only truly closed economy was the world economy itself.

A few other thinkers, scattered across the nation, were working along

similar lines. In California, a young economist, John Rutledge, founded Claremont Economics. In Washington, Norman Ture, Steve Entin, and Paul Craig Roberts (later undersecretary and assistant secretary at the Treasury under Ronald Reagan) were developing a rigorous rationale for tax cuts. In Congress, Jack Kemp became an early and enthusiastic convert, hiring Roberts to write the supply-side legislation.

Still, routine dismissal typically greeted the new thinking. And when the new movement did acquire a name, it came via ridicule. At an economics conference, Herbert Stein dismissively referred to “perhaps two” economists who were “supply-side fiscalists.” Wanniski dropped the “fiscalist,” and the movement became known as “supply-side economics”—in contrast to “demand-side Keynesianism.”

“Supply-side economics” was new. But it also *made* new the old faith of classical economics—a faith in the individual, a faith in the producer, and a faith that, as France’s Jean-Baptiste Say had noted in the nineteenth century, “Supply Creates Its Own Demand.” Economics were not about clever work at the top; they were about providing a stable environment with a reliable currency, removing excess burdens from business, and, finally, getting out of the way. The Keynesians’ hero was a single smart man at a command post in a national capital managing the macroeconomy—an image like that of the Wizard frantically pulling levers behind his curtain in the *Wizard of Oz*. The supply-siders’ hero, by contrast, was an anonymous simple entrepreneur, operating alone—in the cornfields, perhaps, or in a small town shop—far from Emerald City.

Spreading the Word

To advance nationally, the campaign needed heralds. It found one in the *Wall Street Journal*. Backing supply-side economics did not seem an obvious choice for the newspaper. As the near-official organ of the financial world and business establishment, one would expect it to be fighting about corporate taxes, not personal rates. Nonetheless, under the direction of co-author Bartley, it began to publish editorials and op-eds that tried out the new theories. The intellectual Irving Kristol saw that supply-side ideas mat-

tered, and that they might even influence the outcome of the cold war, so he began to advance them in his work. Political economist Paul Craig Roberts, then a congressional staffer, marshaled substantial evidence to show that tax cuts would not reduce revenues. In Kristol's magazine, *The Public Interest*, Roberts published an attack on government forecasting and its inflexible assumptions, entitled "Breakdown of the Keynesian Model."

Another herald was the Manhattan Institute. The institute's first president, Jeffrey Bell, fresh from a run for senator in New Jersey on a supply-side platform, sought to generate a critical mass of intellectual work that would illuminate the supply-side argument. Crucially, he hired George Gilder to serve as director of publications. Bell's advancement of Gilder in turn drew support from William J. Casey, then-chairman of the board of the institute. Most people remember Casey for his service as Ronald Reagan's director of Central Intelligence. But at the time, he was a philanthropist and a Wall Street lawyer. Casey recognized that supply-side economics could bring about stronger economic growth.

Gilder at first seemed an unlikely promoter of any economic doctrine. He was not an economist. Indeed, his first appearance in the national spotlight had come with *Naked Nomads*, a book arguing that feminism destroyed marriage. He had also penned what he called a "nonfiction novel" about the problems of poverty: *Visible Man*. At the institute, Gilder put the final touches on yet another book, this time on the nature of poverty and prosperity. Gilder placed a new emphasis on growth. His draft title was *The Pursuit of Poverty*. But Gilder and his editor, Midge Decter at Basic Books, eventually changed that to *Wealth and Poverty*, echoing the title of Henry George's famous work, *Progress and Poverty*.

Wealth and Poverty advanced several straightforward ideas. The first: the U.S. and Britain were succumbing to nostalgia for the bucolic—the sort of reverie described by William Morris in a poem:

*Forget the spreading of the hideous town,
Think rather of the pack horse on the down,
And dream of London, small and white and clean.*

The second thesis held that the alternative to growth was not pastoral life but stagnation. Gilder argued, thirdly, that high taxes hurt growth. They even helped to create that Monopoly board caricature, the idle rich man in his top hat. Taxes on capital in particular had a perverse effect, lowering the price of luxury relative to the prices of investment and work. In Britain, where taxes on earnings reached 83 percent and taxes on investments could hit 98 percent, it made more sense for a businessman to spend time on the slopes of Gstaad than at his desk working.

The U.S. of the mid-1970s, Gilder noted, had endured a similar, if less dramatic, impediment to enterprise: a capital-gains tax amounting effectively to 49 percent. That high rate deterred business.

The most important thought in *Wealth and Poverty* went beyond nerdy economics to encompass culture: a confiscatory tax regime and a welfare state were immoral, Gilder charged; a minimal tax regime and a free economy, by contrast, encouraged virtue. “In order to take the hill, someone must dare first to charge the enemy bunker,” wrote Gilder. “Heroism, willingness to plunge into the unknown in the hope that others will follow, is indispensable to all great human achievement.”

This argument represented a bold leap and also, in the mood of the period, an improbable one. Decter, a foresightful editor who grasped the importance of Gilder’s ideas, could squeeze together only a \$4,000 advance for *Visible Man* and his next book from Basic. Most people in publishing assumed Gilder’s project would be a non-event.

Wealth and Poverty sold 500,000 copies. It proved successful not only in the U.S., but also in the U.K. and elsewhere. With it, supply-siders entered the national discussion—and found an enormously receptive audience.

Americans might not have been so receptive to the supply-siders’ message had the economy of the 1970s been strong. But the 1970s were a disaster. Inflation raged with the breakup of Bretton Woods, the old international monetary arrangement. The economy shrank at certain points. Prices rose and rationing was employed; wage and price controls ensued. Year in, year out, the nation experienced high inflation and troubling unemployment, a combination that the Phillips Curvers had deemed im-

possible. The papers began to write about the “Misery Index,” the sum of unemployment and inflation; in 1980, it hit 20.6 percent. The Misery Index represented a graphic refutation of the Phillips Curve.

The Tide Turns

Some of the early signs of political activity in support of the supply-siders’ agenda showed up in Massachusetts, New York, and California. In all three places, the potent combination of public debt, inflation, and high tax rates (federal and state) was increasing the financial burden on the middle class to insupportable levels. “Taxefeller,” New Yorkers now called Nelson Rockefeller, the liberal Republican governor who quadrupled the state budget over the decades of his tenure. New York became the most heavily taxed state in the nation; this change squared poorly with its traditional identity as capital of enterprise.

Public fury mounted. In 1978, a California homeowner expressed her feelings upon opening an envelope and learning of a 250 percent property-tax increase. “I forgot all about where I was and what I was doing and fixed like tunnel vision on the bill,” she recalled. “I was filled with fear and also anger and it was such a mix of emotions that I just stood there. I think I vibrated for ten minutes.” For many citizens, the moment had a political intensity similar to the rage that conservatives would later direct against President Clinton—or the anti-Bush rage felt in the run-up to President George W. Bush’s campaign for a second term. California citizens rose up, passing Proposition 13, a draconian constraint on the property tax. But the California revolt also made clear, for the first time in the postwar period, that taxes could be a central issue for voters, perhaps even *the* issue.

Meanwhile, things were happening on the national level. Steiger’s amendment reduced capital-gains taxes by nearly half, to an effective 28 percent. This reduction in turn spurred the very sort of innovative activity that Gilder had predicted. In 1977, the year before the rate cut, venture capital in the U.S. totaled \$39 million. Within six years after the cut, that figure had swelled to \$2 billion. Suddenly, as one venture capitalist told

the *Wall Street Journal*, it was a “snap” to raise money—notwithstanding the high interest rates of the early 1980s. Silicon Valley began to yield its fruit. The challenges and meanings of the tax rebellions were chronicled in another Manhattan Institute project: *Secrets of the Tax Revolt*, by James Ring Adams, a writer and editor at the *Wall Street Journal*.

These popular validations of the supply-side message were not lost on a campaigning Ronald Reagan. As an actor, Reagan had experienced firsthand the discouraging effects of high marginal rates. Nowadays, when we hear about a candidate summoning think-tank-scholar types to his home state for advice, we think of Bill Clinton in Arkansas or George W. Bush at the governor’s mansion in Austin. But Reagan was one of the first to bring in tutors in this systematic fashion. From a headquarters in Los Angeles—convenient to LAX—he summoned think-tank scholars and university academics to talk policy. Not all of them were supply-siders, by any means, and a few were high-end Keynesians. Still, Reagan policy as it developed was very definitely free market and very definitely un-Keynesian. The consultants included Congressman Jack Kemp, George Shultz, former treasury secretary William Simon, Walter Wriston of Citibank, Alan Greenspan, Arthur Burns, Milton Friedman, Martin Anderson (who had also served on the Nixon campaign), James Buchanan, and many others.

As Anderson later noted in an insightful book, supply-side ideas came easier to Reagan than they did to many politicians because of a supposed disadvantage: his age. Reagan was so old that he had missed Samuelson and the typical college indoctrination into Keynesianism. Economics as universities taught it in the teens, twenties, and thirties, including at Reagan’s alma mater, Eureka College of Illinois, meant classical economics. It contained little dogma about aggregate demand or inflationary spirals.

In August 1979, Anderson penned “Policy Memorandum Number 1,” which laid out for candidate Reagan both problem and solution. The problem was that Keynesian article of faith: “that any attempt to reduce inflation would result in more unemployment”—the Phillips Curve. A new president should focus on economic growth. There were

other “musts”: the president must “reduce federal tax rates”; must reduce regulation; and must develop an economic policy, especially a tax policy, which was “efficient, dependable, with no abrupt changes.” This last idea was important because Carter had tinkered constantly with taxes and, through his Treasury secretary, the dollar; such caprice hurt the anonymous, struggling entrepreneur. In sum, Anderson argued, the policy of a Reagan administration ought to “give the people valid hope for their personal economic future.” Thus, barely three years after its christening, supply-side economics had become the platform of a winning presidential candidate. Everyone sensed that the time had come to follow up on Steiger’s capital-gains start and reform the tax code along supply-side principles.

Both before and after Reagan’s election, supply-side notions faced numerous challenges. Many economists and experts warned against them, arguing that the tax cuts would cause dangerous inflation. William Miller, President Carter’s Treasury secretary, warned that “it would be a great hoax on the American people to promise a tax cut that sets off a new price spiral.” Democrats were often contemptuous, but so were many Republicans.

There was trouble in the Reagan camp, too. James Baker, the president’s advisor, warned that the Reagan tax plan meant a deficit, and a candidate could not be seen to be allowing for one. “Damn it, Marty,” Anderson recalls him complaining over the phone, “we can’t have the government propose a deficit of \$50 billion a year. The press will kill us.” After the election, David Stockman at the Office of Management and Budget turned against the administration early on, arguing that planned rate cuts would generate a deficit so large as to bring disaster. Investigative journalist William Greider documented Stockman’s betrayal in *The Atlantic Monthly*.

Many on the Reagan economic team knew that rate cuts, while spurring overall growth, might not entirely offset the nominal cost of the tax cuts. As Bruce Bartlett notes, they repeatedly warned that rate cuts would “cost” money; in the longer term, though, those cuts were worth it.

Yet Reagan held to his general supply-side conviction that deficit

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concerns were subordinate to his tax cuts. (Early in Reagan's first term, William Casey gave the president a copy of *Wealth and Poverty*. While recovering from the assassination attempt against him, Reagan was seen carrying a copy of the book; the president reportedly also gave out copies of the book.) Reagan cut rates in his first term and cut them again in his second. He repeatedly played down worries about the deficit, arguing that the rate cuts would promote growth and that his cold-war defense outlays would also pay off eventually. The decade's principal economic achievement was the 1986 cut to the crucial top marginal rate on the income tax, bringing it down to 28 percent from 50 percent—or, if you wanted to go all the way back, from the 70 percent that had prevailed when the rate was at its peak. Instead of multiple rates there were now two, 15 percent and 28 percent. Corporate rates also came down. Meanwhile, tax breaks were pruned away.

The 1986 law involved enormous compromises for the supply-siders. Too few lawmakers bought their argument that rate cuts would generate growth and increased revenues. Federal law mandated that the nominal "cost" of the tax cuts had to be compensated for with boosts in other rates; the 1986 tax act must be what was called, in technical lingo, "revenue neutral." This requirement forced an increase in the capital-gains rate, anathema in supply-side economics. Supply-siders and, indeed, many non-supply-siders believed that income was taxed more than sufficiently via the personal income tax and corporate tax; to tax it a third time as capital gains seemed especially wrong. Other first principles also were sacrificed—the new law, for example, eliminated the deductibility of credit-card interest.

Overall, however, the reformers achieved what Reagan and the supply-siders had sought: a broader base and a more comprehensible system. The latter reform would help restore the badly damaged contract between taxpayer and government. If people could understand their tax bills, they could trust their government, the thought went, and so would be inclined to work harder.

Furthering the Supply-Side Cause

Today, we think of the 1986 tax cut as all Reagan, but in fact many Democrats played roles. Dan Rostenkowski, chairman of the House Ways and Means Committee, for example, worked with the president to produce the bipartisan legislation. So did other Democrats; in his day, even Bill Bradley of New Jersey was a sort of supply-sider. These Democrats were willing to support the tax reform in part because the formerly extreme tenets of low top tax rates, low rates overall, and simplicity had now become mainstream.

And the Manhattan Institute worked to keep them there. In the early 1980s, the institute sponsored the work of Warren T. Brookes, perhaps the clearest of all the supply-side writers; an anthology of his work, much of which had originally appeared in the *Boston Herald-American*, appeared in 1982 under the title *The Economy in Mind*. Brookes, like Gilder, sounded a distinctly moral—even religious—theme. In an essay entitled “Goodness and GNP,” Brookes went so far as to ask: “Without the demand to strive and grow, implicit in the ideal of God as Father (or divine principle) would mankind continue its search for a higher human standard and for the perfection the Gospels urge as our birthright?”

In 1983, Bruce Bartlett, then executive director of Congress’s Joint Economic Committee, and Timothy P. Roth, a University of Texas professor, edited and published *The Supply-Side Solution*, another Manhattan Institute project. This volume brought together empirical and theoretical work by academic economists, suggesting that federal policies that were more incentive-oriented would yield great productivity levels in the U.S. economy. The economists also looked at the consequences of over-taxation abroad. Peter Gutmann, for example, contributed an essay pointing out that lower tax rates would enable the federal government to capture tax revenues from the (significant) share of the economy that had, because of high rates, operated in off-the-books black or gray markets.

All of this supply-side talk and action did not mean that economic trouble disappeared overnight. There was the ghost of inflation with its high interest rates, as well as a widening deficit, which the supply-siders’

critics never ceased to bring up. But many good things did happen in the train of the 1980s changes. The economy grew at a faster rate. The market boomed. The 1980s saw the creation of tens of millions of private-sector jobs, in astounding contrast with stagnant European economies. Stagflation was overcome, thanks in part to tighter monetary policy.

Lastly—and this point is often neglected—something else happened. Ronald Reagan’s cold-war campaign paid off. With that war over—albeit after Reagan’s departure from the stage—new possibilities opened for economic growth across the globe. Decreased defense spending brought a peace dividend that yielded the surplus that Reagan’s opponents had hankered after. In other words, the supply-siders’ essential wager, that a wider deficit would be a useful sacrifice, proved correct.

Codifying this great success was another Manhattan Institute book, *The Growth Experiment*, by Larry Lindsey, a bearded young Harvard professor. Lindsey looked at tax rates and returns, as well as growth rates, using the National Bureau of Economic Research’s TaxSim model, which he had helped develop with the NBER’s Martin Feldstein and a number of his staffers. The model also looked at the increase in the national debt from 1980 to 1987. It turned out that only \$112 billion, or one-fifth of the new debt, resulted from the Reagan rate cuts. Balancing the increased deficit, moreover, were the low inflation and strong growth of the period.

What About the 1990s?

Some have said that the 1990s disproved the supply-siders. After all, George H. W. Bush began the era by undoing some of Reagan’s work and raising tax rates, including the beloved top marginal rate. Then along came President Clinton, who raised rates some more. Nonetheless, the economy expanded mightily.

To this argument, supply-siders offer four rebuttals. The first: the tax increases of Bush I and Clinton, while punishing, did not bring rates back to the levels that obtained when Reagan took office. So a supply-side effect remained at work. The second: the 1990s growth had been baked

in the cake; the prep work of earlier supply-side tax cuts, especially the Steiger capital-gains cut of 1978 and the 1980s income-tax cut, made it inevitable.

Third, the supply-siders point out, it takes the economy a long time to get over the damage of inflation. By including tight money as part of their recipe, the supply-siders taught the U.S. that inflation did not have to be a prerequisite for growth. The full benefits of this approach came only in the late 1990s, when, even in the face of strong growth, rates stayed low. When the ten-year Treasury note hit a generational low of 3.11 percent in June 2003, this represented, in effect, international recognition that U.S. policymakers were not so likely to abuse Keynes's old monetary tool in the future.

The final counterargument is that the Clinton administration itself exploited supply-side thought. Secretary of the Treasury Robert Rubin led Congress in cutting the capital-gains tax in the late 1990s. He knew that lower rates would provoke a storm of transactions as investors took advantage of the more favorable climate. He was right, and the fresh revenue helped drive the budget into surplus.

Even skeptics in the old Republican camp reconsidered. In April 2003, James Baker wrote in the *Wall Street Journal* that he now rejected his former view that balancing the budget was more important than tax relief. "I was wrong. That's why I often refer to myself on the issue as a 'reformed drunk.'" David Stockman acknowledged a similar shift, though less directly, on the television program *Kudlow and Cramer*. "The hidden secret" of the U.S. economy," he said, "is tremendous productivity in manufacturing—in the U.S., something we couldn't imagine nor would any conventional economist have thought possible before the Reagan supply-side revolution."

The Supply-Side Future

Where does President George W. Bush fit into this story? One of the Manhattan Institute's friends—Larry Lindsey—carried supply-side thought like a flame into the administration, where it has burned throughout

President Bush's first term. The president cut taxes again and again. His work included a reduction in the top marginal rate, the goal central to the supply-side approach.

A purist would note, however, that President Bush has betrayed several of Reagan's old principles. For starters, he made many of the cuts apply to low earners, a less efficient move by supply-side standards. Second, the Bush administration ignored the Reagan precept that simplification and constancy are important. The Bush administration changed rates constantly, a habit that has a Carteresque aspect; there was also neglect of the dollar.

Another Bush failing is visible on the moral front. Instead of arguing that a compassionate government gives its citizens more freedom, President Bush has tended to compartmentalize his policy work, keeping "tax work" separate from "compassion work." His compassion work has included a disastrously expensive new federal entitlement: prescription drugs for senior citizens. The tacit Bush message weakens the conservative and free-market case. It makes future tax increases harder to avoid. The expense of new entitlements may be so great that no tax cut can offset it. The new entitlements may force even supply-side-friendly governments to raise taxes—thereby making the supply-siders seem like hypocrites. In addition—and this is a subtler point—those who argue against entitlements because they genuinely believe that such government "help" will have little social benefit will find themselves labeled "uncompassionate."

Finally, supply-side theory in the U.S. has been to some degree a casualty of its own success. After all, from the point of view of business or the individual, a rate cut from 70 percent to 50 percent or 40 percent is much more dramatic than a cut from, say, 39.6 percent to 35 percent. Taxes may be high today, but they are much closer to Art Laffer's optimal point than they were in the 1970s or early 1980s. One senses that the future of the tax cut movement, as Bruce Bartlett has noted, lies not in rate cuts but in fundamental reform.

Still, the supply-siders and their free-market friends have cause for celebration. Their idea has generated amazing prosperity, and has done

more than any other single contributing factor to assure U.S. economic preeminence. The old talk of trade-offs is gone. Neither Democratic nor Republican candidates argue that tax cuts are “inflationary.” There may be tax hikes, but they are much harder to sell than they once were. The planned reform of Social Security emphasizes privatizing and individualizing the program—both supply-side focuses. The supply-siders’ campaign is now three decades old, and it is they who command the high ground.

Editor’s note: Robert Bartley was working on this collaborative essay, at times from a hospital bed, when he died of cancer on December 10, 2003, at the age of 66.