The Washington Times
www.washingtontimes.com

Oblivious to reality

By Richard W. Rahn
Published April 5, 2007

If you knew how to make life better for your fellow Americans, would you? The political class in Washington constantly claims it "cares about you," but when it comes to policy many do just the opposite.

Most people understand the Republicans messed up by allowing nondefense spending to grow faster than the economy. The Democrats ran against the irresponsible Republicans by claiming they would be "fiscally responsible." So, rather than present a budget that would reduce the growth rate of domestic spending, they have just proposed one that would increase it, even above Republican proposals, and require increases in taxes. You can only wonder if they are even more brain dead than the Republicans.

The empirical evidence supports precisely what good economists have said for years. Increasing tariffs, economic regulations, taxes and tax rates, and government spending will all serve to lower economic growth and vice versa. These economic truisms are well-known, except to the oblivious, and as they say, not only work in theory but also in practice. Keeping the tax burden, regulations, trade practices, and government spending constant, along with a reasonably predictable noninflationary monetary policy would probably result in average U.S. growth in gross domestic product of approximately 3 percent yearly. But, depending on what policy changes are made to each of the above variables, we can either do better or worse.

In 1930, the U.S. made a huge blunder by greatly jacking up tariff rates (the Smoot-Hawley Act), and that Act, along with totally wrongheaded monetary policy, gave us a more than decadelong Great Depression. Fortunately, the trend has been for trade liberalization which has resulted in the average U.S. tariff rate being reduced from more than 10 percent in the 1960s to roughly 2 percent today.

The reduction in tariff rates has reduced prices for consumers and caused the country to grow more rapidly by lowering the cost of raw materials and components for producers. Serious people have understood the benefits from free trade since the late 1700s, yet many still equivocate when it comes to trade policy.

Even though those in the Bush administration have largely been free traders, they have done dumb things, such as imposing tariffs on steel (now removed) and just last week putting a tariff on "coated paper" from China. Many members of Congress resist further

trade liberalization and advocate trade restrictions, again being oblivious to the benefits of free trade.

Many economic benefits of better trade policy have been negated by counterproductive regulatory policies over the last half-century. Too few regulations are subject to serious cost-benefit analysis, and excessive financial regulation (such as Sarbanes-Oxley) has caused America to lose ground to foreign competitors.

TAX RATES, FEDERAL DOMESTIC SPENDING & ECONOMIC GROWTH

Period of Time	**Tax Rates**	**Domestic Spending** (as % of GDP)	**Economic Growth Rates**
1983-1989	Large Reduction	Falling	4.3%
1990-1996	Increased	Rising	2.2%
1997-2001	Small Reduction	Falling	3.5%
2002-2003	No Change	Rising	2.2%
2004-2006	Reduced	Constant	3.5%

As the chart clearly shows, the economy grows faster when the growth in government spending (at least nondefense) is kept below the rate of economic growth so the real burden of government declines. The shorthand reason is that the private sector tends to operate far more efficiently than government; so when the private sector is relatively larger, the economy grows faster and vice versa.

Government spending fell as a share of GDP from 1983-1989 and from 1997-2001, both of which were prosperous periods.

The chart also clearly indicates lower tax rates lead to higher growth because they reduce the disincentives for working and investing. We had major tax reductions in 1983 which helped fuel the economic expansion from 1983-1989, but then former President George H.W. Bush increased taxes in 1990, leading to the economic slowdown. President Clinton again increased taxes in 1993 but reversed course in 1996 by reducing the capital-gains tax rate as a result of pressure from the Republican Congress, and immediately the economy began to grow more rapidly.

Only after current President Bush cut tax rates in 2003 and began to moderate his domestic spending binge, did the economy resume growing at above-average rates.

Looking at the historical evidence as well as theory, if the Democrats get their way and repeal the Bush tax cuts and increase government spending, it would be expected that the economy would then grow only about 2 percent annually, which would mean rising unemployment and falling real incomes for many.

We know from the Reagan years that moderately good economic policies can cause the average economic growth rate to rise above 4 percent for a number of years. Just think of what the economic growth rate would be if we abolished all impediments to free trade, had no tax rate above its long-run welfare maximizing rate, and made sure every government regulation and spending program was totally justified on a real cost-benefit basis.

Growth rates do matter -- at a 2 percent yearly compounded growth rate it takes 35 years for income to double, at 4 percent it takes 18 years for income to double, and at 7 percent only 10 years for income to double.

We all suffer because of those who are oblivious to or deny economic reality.

Richard W. Rahn is the chairman of the Institute for Global Economic Growth.

Direct link: http://www.washingtontimes.com/commentary/20070404-091438-5280r.htm

Copyright © 2007 News World Communications, Inc. All rights reserved.