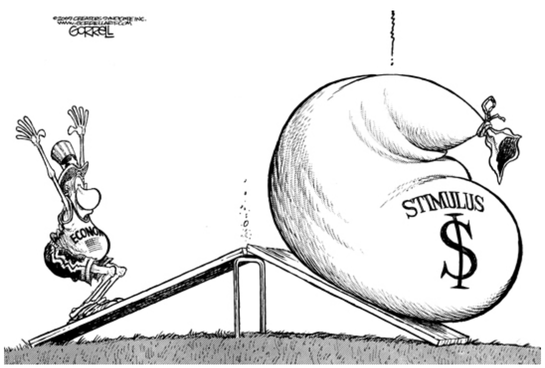
The Experiment

By Richard W. Rahn



ECONOMIC POLICIES AND OUTCOMES

	POLICIES		OUTCOMES		
President (last full year of term)	**Non-Defense Spending as % of GDP**	**Top Marginal Tax Rate**	**GDP Growth Rate (%)**	**Unemployment Rate**	**Consumer Price Index**
Carter (1980)	**16.8**	**70.0**	**-0.2**	**7.1**	**13.5**
Reagan (1988)	**15.4**	**28.0**	**4.1**	**5.5**	**4.1**
Bush-41 (1992)	**17.3**	**31.0**	**3.3**	**7.5**	**3.0**
Clinton (2000)	**15.4**	**39.6**	**3.7**	**4.0**	**3.4**
Bush-43 (2008)	**16.6**	**35.0**	**1.3**	**5.8**	**3.8**
Obama	**higher**	**higher**	**???**	**???**	**???**

Now that President Obama has obtained his "stimulus package" to revive the economy, the operative question is, "Will it work?" Over the last three decades, six U.S. presidents (including the current one), Democratic and Republican Congresses, and the Federal Reserve (under four different chairmen) have tried a variety of economic policies with very different outcomes.

President Obama and the Democratic Congress are now headed on a new course, and to judge its likelihood of success, it is useful to look at history (please note accompanying chart).

President Jimmy Carter inherited a growing economy but one with relatively high inflation and high unemployment. He left office with the economy in a recession, high unemployment, and a record high inflation and interest rates (the prime rate at one point had reached 21 percent). Mr. Carter's policies were to maintain the very high marginal income tax rates in effect at that time, coupled with a small expansion in the relative size of government.

Mr. Carter had appointed G. William Miller as Federal Reserve chairman, who proceeded to engage in a very rapid monetary expansion. The inflation disaster caused by the excessive monetary expansion caused Mr. Carter to replace Mr. Miller with Paul Volcker at the very end of his administration.

President Reagan inherited an economic situation even worse than the one President Obama has. When Reagan took office, the economy had been in recession for about a year, the unemployment rate was almost identical to today's, but the labor force participation rate was smaller, and inflation was out of control. At the time, the newspapers were filled with stories about the "worst economy since the Great Depression" - which, unlike today, was true, and the economic establishment seemed to be bereft of ideas of what to do.

Credit markets were in a mess, and both businesses and consumers were not borrowing because they could not afford the interest rates. President Reagan, unlike his critics, had a clear plan to revive the economy, which included: monetary restraint to stop inflation; large reductions in marginal tax rates to renew the incentives to work, save and invest; and a reduction in nondefense spending as a percentage of gross domestic product (GDP).

Unlike other recent presidents, Reagan actually kept and delivered on his promises, which resulted in high growth (7.2 percent in 1984 alone) and large reductions in the unemployment rate - particularly, inflation. He stuck with Mr. Volcker and his monetary restraint because he understood inflation had to be brought under control, even though he also knew it would necessarily prolong the recession. How many of today's politicians would be willing to take the heat for the long run good?

The first President Bush had promised not to increase taxes ("read my lips") and to implement a "flexible freeze" to keep the growth of government spending to less than that of nominal GDP. Instead, he almost immediately abandoned his spending restraint promises and ultimately his "no new tax" pledge. The result was a drop in growth from the Reagan years, including a brief recession in 1990, and a rise in unemployment.

President Clinton was elected in 1992 on a program that sounded much like the 1988 Bush promises of no new taxes and spending restraint. Mr. Clinton quickly reneged on his no new tax pledge but did, ultimately, deliver on his spending restraint pledge (with a strong push from the new Republican Congress after the '94 election). The Fed also delivered low inflation during the Clinton years, until 2000. The result was strong economic growth until the end of the administration when spending shot up and the economy went into a recession just as his successor took office.

The second President Bush came into office promising to restrain the growth in government spending and cut tax rates. He partially learned from his father's mistake and did keep tax rates relatively low, but (like his father) he failed to control spending and even non-defense spending rose as a share of GDP. Fed Chairman Alan Greenspan kept interest rates far too low after the 2001 recession, which fueled the predictable collapse of the housing bubble. This, in turn, caused the recession with an unemployment rate of more than 7 percent when he left office and much of the current financial mess.

President Obama had promised to restrain spending growth but increase taxes on upper income groups. Yet, the just passed "stimulus" bill represents the biggest single growth in government spending since the Great Depression. If he raises taxes, including just letting the George W. Bush tax rate cuts expire at the end of 2010, his actual economic policies will be like those of the first President Bush, but on steroids. (Note: Presidents Herbert Hoover and Franklin D. Roosevelt both greatly increased taxes and government spending; and as the result, the 1930s was the only decade in American history without economic growth.)

Again, during President Reagan's years, tax rates came down sharply, government spending growth was restrained, and the economy grew rapidly. During the Clinton years, top tax rates were increased but government spending was restrained for most of his term, and the economy grew rapidly until the last few months of his tenure.

But during the years that President Carter and the two President Bushes were in office, nondefense government spending grew relative to the economy, growth rates were depressed and unemployment rose. Why should we expect a different result this time?

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http://www.washingtontimes.com/news/2009/feb/18/the-experiment/