

**THE ECONTRARIAN**  
YOUR ALTERNATIVE TO THE ECONSENSUS

**Some Ugly, Thorny Things Debunk A Faith Thing**

October 20, 2006

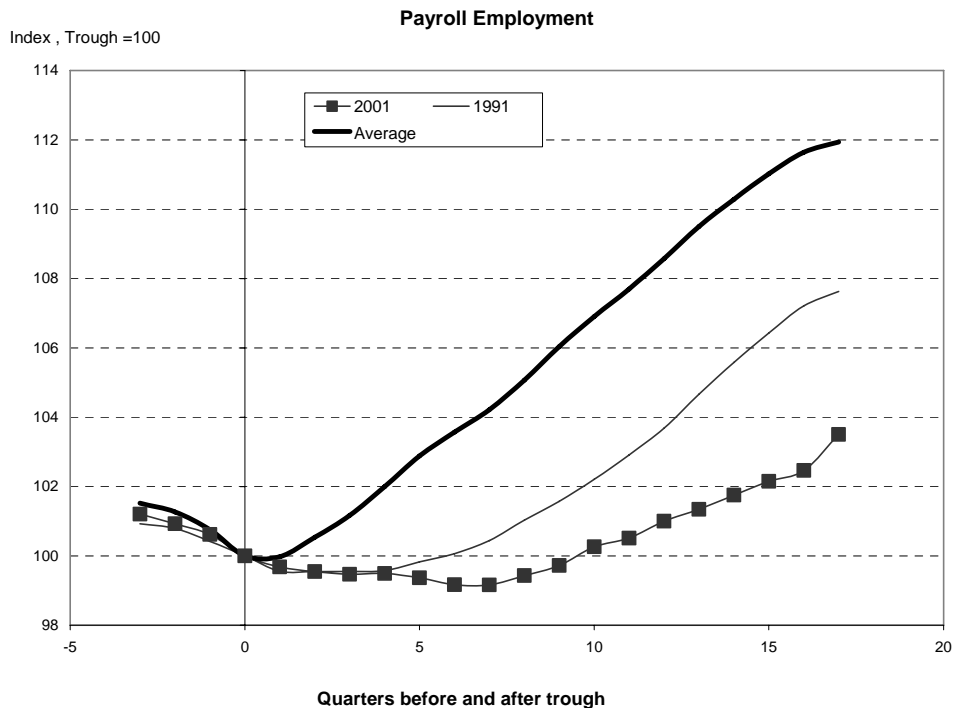
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This past week the op-ed page of *The Wall Street Journal* published two essays dealing with “things.” On October 17<sup>th</sup>, Brian Wesbury penned a piece entitled “It’s a Faith Thing,” in which he argued that, contrary to the conventional wisdom of cynics and pessimists (like me?), the U.S. economy is thriving in large part due to President Bush the Younger’s tax cuts. Wesbury cited some revised data in support of his thesis. Then on October 19, Joseph Epstein’s piece, “Ugly, Thorny, Things,” appeared on *The Journal*’s op-ed page. In it Epstein argued that the past 50 years have been characterized by ugly, thorny facts debunking lofty ideas. In what follows I will bring to bear some ugly, thorny facts that debunk Wesbury’s lofty idea that the current administration’s tax cuts have resulted in a supply-side Nirvana.

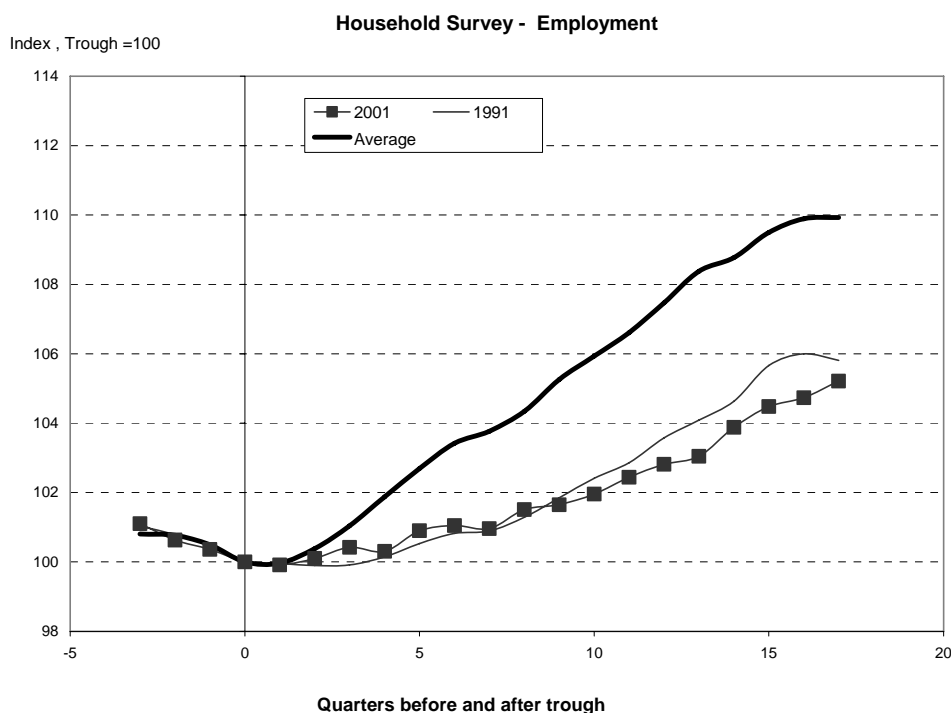
Wesbury makes a big deal out of the extra 810,000 nonfarm payrolls found by BLS in its first pass at its annual benchmark revision. But Asha Bangalore shows in Chart 1 that even with these extra workers, payroll employment growth in this alleged tax-cut-induced expansion is the weakest in any expansion dating back to 1961.

Chart 1



Wesbury argues that the establishment (employer) nonfarm payroll employment count underestimates employment because in this new tax-cut-induced entrepreneurial economy all the action is in small businesses and self-employment. The establishment nonfarm payroll survey excludes the self-employed and may not capture the employment created by new small businesses that are not quickly included in the survey. So, a more accurate estimate of employment might be found in the household survey, according to Wesbury, even though the household survey is based on a much smaller sample. Uh oh. Asha again provides some ugly, thorny facts that debunk another one of Wesbury's lofty ideas. Chart 2 shows that the *household* survey also shows the weakest employment growth of any economic expansion dating back to 1961. Admittedly, household survey employment growth is not *much* lower in the current expansion vs. the 1991 expansion. But remember, the 1991 expansion was immediately preceded by the tax *increase* of President Bush the Elder and included the 1993 tax *increase* of President Clinton.

Chart 2



Before leaving the subject of the self-employed and small businesses, let's examine the share of national income going to nonfarm proprietors, the entrepreneurial heroes of the supply-side tax revolution. As shown in Chart 3, their share of the economic pie has been rising during Bush the Younger's presidential tenure. But notice that this just appears to be a continuation of a trend that started in the early 1980s and that continued through the tax-raising Clinton presidential tenure. So, it is difficult to know whether it is tax cuts or something else that is generating this increased relative proprietors' income.

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Chart 3

Nonfarm Proprietors' Income / National Income

%

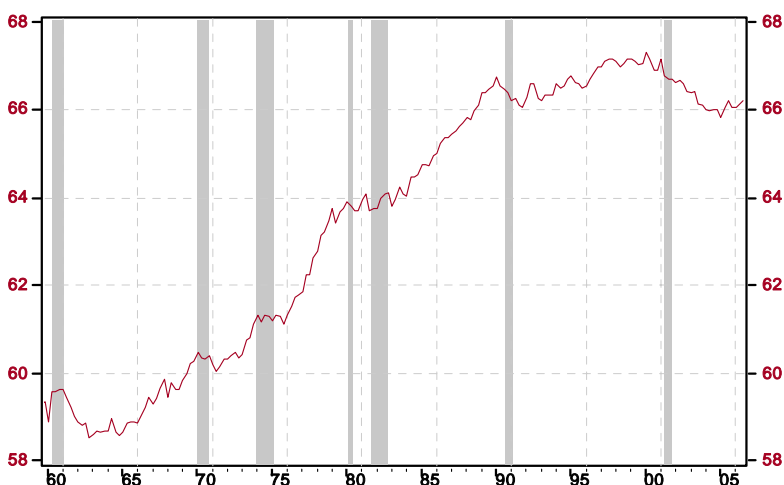


Supply-side tax cuts are supposed to encourage an increased work effort because, with lower marginal tax rates, the worker gets to keep more of any extra earnings. It would logically follow then that a greater proportion of employment age people would enter the labor force. That is, if marginal tax cuts have a big supply-side effect, the labor participation rate should increase. Uh oh. Chart 4 has some ugly, thorny facts that debunk this lofty supply-side idea. Every economic expansion starting with the one in 1961 has been accompanied by an increase in the labor participation rate – that is, *except this current supply-side induced one.*

Chart 4

Civilian Participation Rate: 16 yr +

SA, %



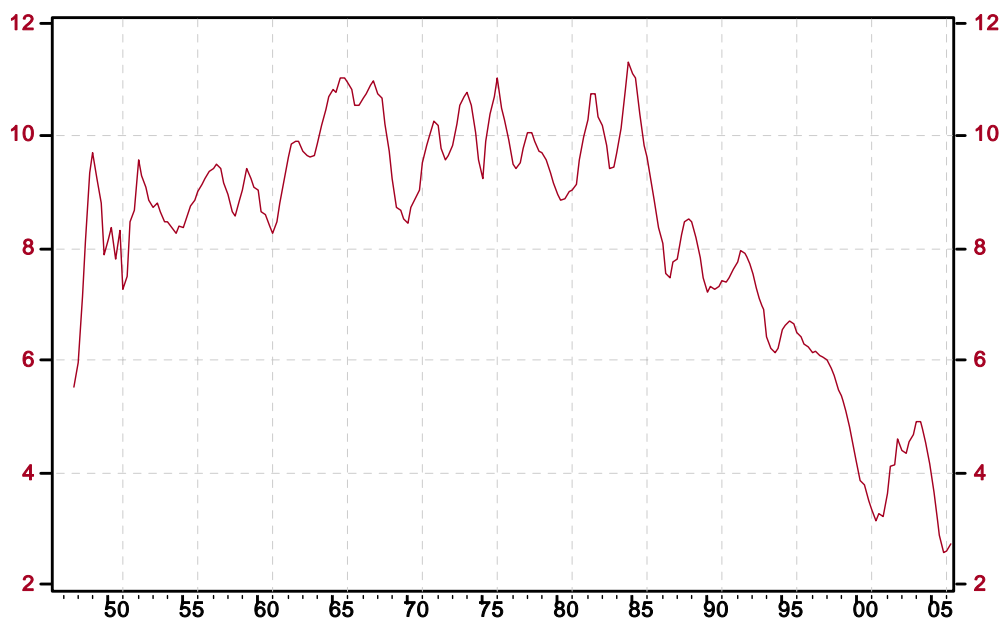
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Supply-side tax cuts are also supposed to result in increased saving and business investment. How has this played out under Bush the Younger's tax cuts? Let's go to the charts. In Chart 5 we can see that net private saving – personal plus business – in relation to GDP is now plumbing post-war record lows. What about business investment and the ratio of the business capital stock to the total capital stock? Chart 6 shows that although real private nonresidential investment as a share of real GDP is on the rise again, its share of real GDP rose sharply and to a post-war record high during the Clinton administration's tenure – a tenure in which *tax rates were raised*. Moreover, as shown in Chart 7, in 2005 the net real business capital stock as a share of the net real total capital stock, which includes houses, SUVs and B-2 bombers, was at its lowest percentage since 1978 after having come within a hair of its 1985 post-war record in 2000. As you may recall, 2000 was the last year of the tax-raising Clinton administration. Uh oh. More ugly, thorny facts that debunk Wesbury's lofty idea.

Chart 5

**Net Private Saving as % of GDP**

4-qtr MovingAverage



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Chart 6

Real Private NonRes. Fixed Investment / Real GDP

%

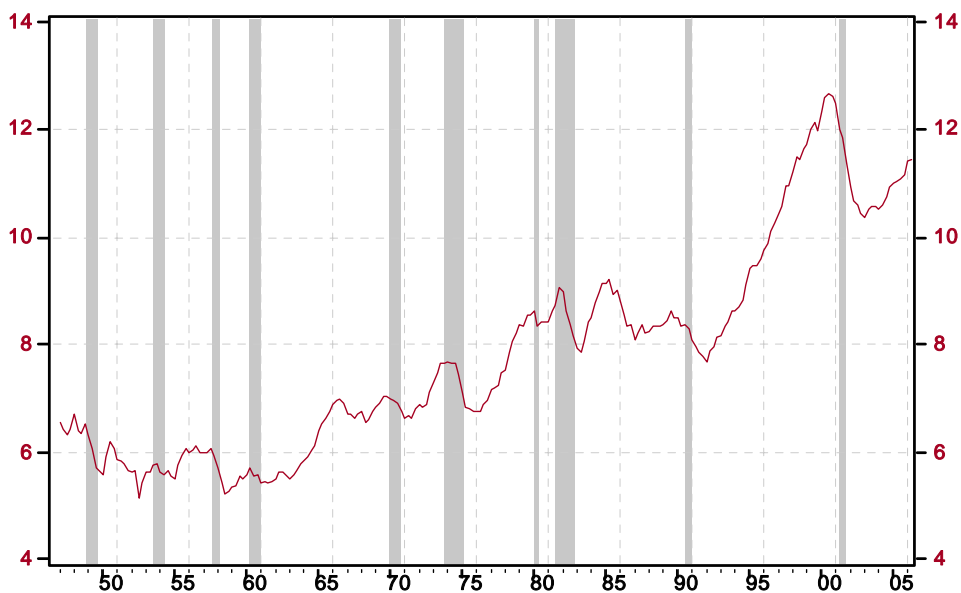
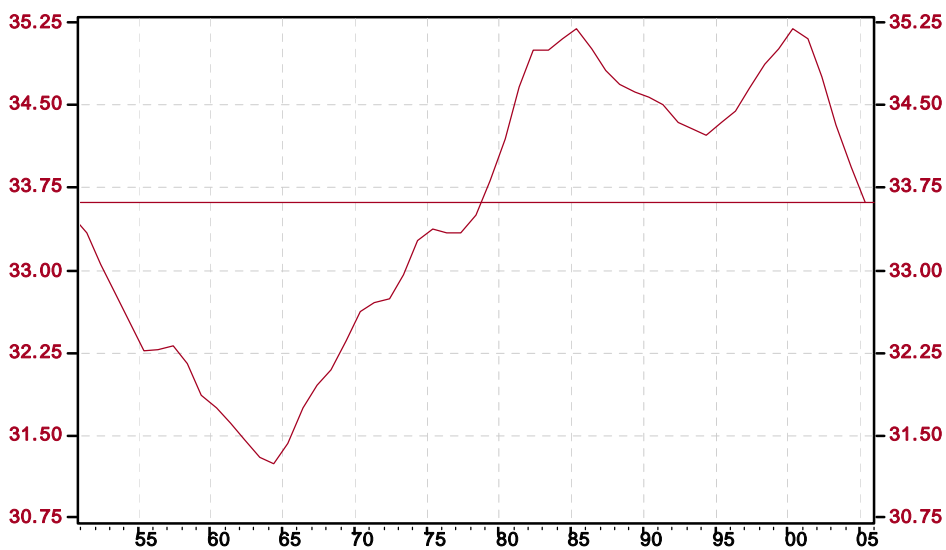


Chart 7

Net Real Prvt NonRes Fixed Capital Stock / Net Real Total Capital Stock

%



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Lastly, with regard to tax cuts and economic performance, how does Wesbury reconcile his faith in tax cuts with the fact that the *longest* U.S. economic expansion on record occurred between 1991 and 2001, years in which tax rates were *increased*?

Wesbury began his essay citing the new highs being set in the Dow Jones 30 Industrials stock average as proof positive of the wonders of Bush the Younger's supply-side tax cuts. But wait a minute. Aren't the principal beneficiaries of these supply-side tax cuts supposed to be the entrepreneurial upstarts represented in the NASDAQ rather than the Dow dinosaurs? Let's see, the NASDAQ closed at 2340.94 on October 19, 2006, about where it was trading in early March of 1999 and at a level 54% below the NASDAQ's March 10, 2000 peak (see Chart 8).

Chart 8  
Stock Price Index: NASDAQ Composite  
2/5/71=100 (I)



But keep the faith, Mr. Wesbury. That new-era Lucent Technologies stock that you were touting back in the late 1990s may yet get back to its December 20, 1999 high of \$63.224 from its October 19, 2006 close of \$2.36 (read it and weep in Chart 9).

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Chart 9



Now, I don't want you get the idea that this has been a politically-partisan diatribe on my part. The Clinton administration made claims that the relatively good economic performance occurring on its watch was the result of the tax increases it implemented. According the Clinton interpretation, these tax increases helped reduce the federal budget deficit and, in turn, helped hold down bond yields. I have pointed out elsewhere some ugly, thorny facts that bond yields started rising as economic activity took off in 1994 and the budget deficit came down.

My not-so-lofty idea is that monetary policy and the condition of the U.S. banking system has had more to do with economic performance in the past 15 years than tax cuts. For example, Chart 10 shows that when President Clinton took office in 1993, U.S. commercial banks were very reluctant to extend credit to the private sector because of the hits to capital that they had taken in the late 1980s and early 1990s. The Fed had been cutting the Fed funds rate to then unheard of low levels, 3%, with little success in the way of generating a consistent pick up in economic growth. But about the same time as the Clinton administration raised taxes, 1993, the banking system was on the mend and was easing its lending terms to the business sector. Bank loan growth to the private sector accelerated and the economy began to expand in a more typical cyclical fashion – similar to what is happening in the Japanese economy today.

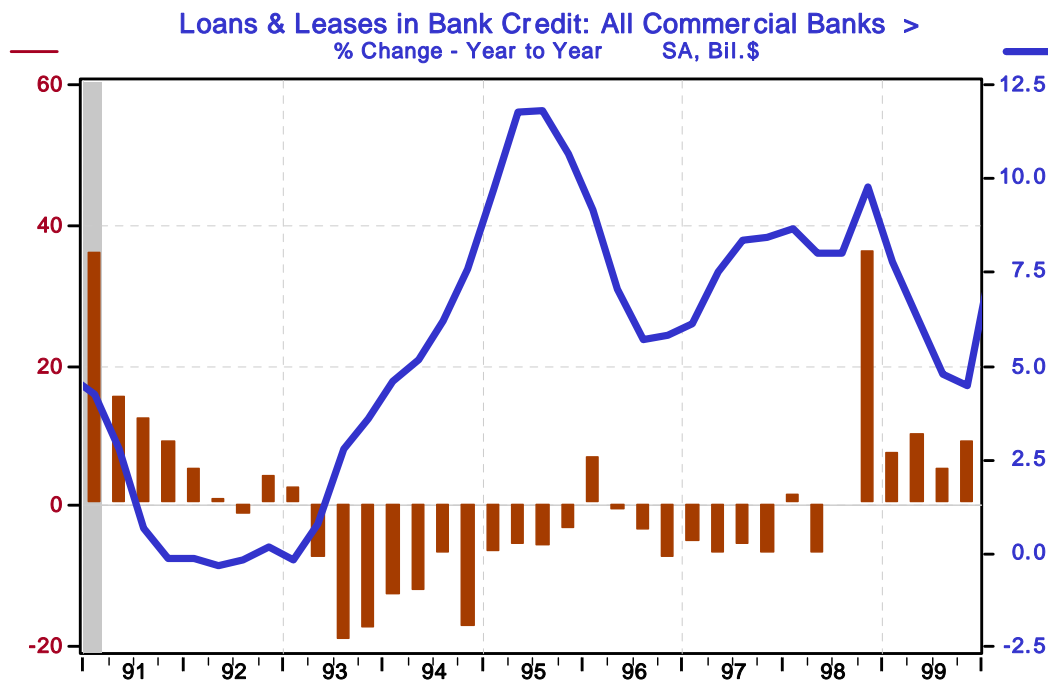
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My not-so-lofty idea was that it was not the Clinton tax cuts that led to the longest economic expansion in U.S. history, but rather the combination of cheap credit being offered to the banking system by the Fed and the banking system's ability to pass on that cheap credit to the private sector starting in the second half of 1993.

Chart 10

< FRB Sr Officers Survey: Banks Tightening C&I Loans to Large Firms %



Source: Federal Reserve Board /Haver Analytics

I agree with Wesbury that marginal tax cuts are a good economic thing. What I disagree with is Wesbury's seemingly blind eye to all "things" other than tax cuts when explaining economic activity.

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