Chapter VIII
The Current Debate: Supply-Side vs. Demand-Side Economics

Since the 1980s the dispute between demand-side and supply-side economics has dominated the debate over U.S. tax policy.¹ Both sides acknowledge that tax cuts can stimulate the economy during a downturn, but the two sides view the problem, as it were, through opposite ends of the telescope.

Demand-siders emphasize the centrality of aggregate demand in driving economic expansions and contractions. When demand-siders discuss the potential benefits of cutting taxes during a recession, they emphasize the need to put money into the hands of the vast mass of consumers. The point is to increase consumer spending, which in turn will stimulate increased production—resulting in greater employment, investment, and a continuing growth in Gross Domestic Product (GDP). Demand-siders therefore favor tax cuts that are weighted toward the middle and lower ranks of earners, who will naturally tend to spend more of any money they receive from tax reductions.
Supply-siders turn this approach on its head. As their name implies, supply-siders see production, or supply, rather than demand as the main engine of U.S. economic growth. Their emphasis is on increasing business investment: in the supply-siders’ view, higher rates of investment will lead to higher rates of growth in GDP. For supply-siders, a key feature of the tax code is its “incentive effects.” By changing individual economic incentives, they believe, they can change economic behavior by encouraging more business investment by upper-income taxpayers (the investor class).

Supply-siders speak of lowering marginal tax rates across the board to increase incentives to “work, save, and invest.” But the supply-siders’ emphasis (and the feature that makes their program controversial) is clearly on lowering the top marginal rate, and the reason is its presumed impact on U.S. economic growth. While supply-siders commonly argue that tax rate cuts will increase incentives for “work effort” or productive economic activity across the board, the controversial aspect of their program is their heavy focus on lowering the top marginal rate, with the avowed purpose of boosting business investment or “capital formation.”

The key contention of supply-side economics is that lowering the top marginal income tax rate increases the incentives of business owners to invest in their businesses, which in turn results in increased production, employment, and growth in GDP. The upshot of all this is that supply-siders favor tax cuts weighted toward the highest-income taxpayers.

Importance of Issue to Current Policy Discussion
Supply-side claims have been central to recent policy debate on taxation. The emphasis on reducing the top marginal tax
rate to accelerate growth by spurring investment was clear in congressional testimony at the very beginning of the Bush administration by R. Glenn Hubbard, then-chairman of President Bush’s Council of Economic Advisers (CEA): “The key to the President’s plan is its focus on reducing marginal tax rates. We are now quite familiar with the notion that accumulating physical capital, human capital . . . and new technologies is the heart of sustained economic growth and prosperity. There is now a large body of evidence that improving marginal incentives . . . is the key to ensuring these investments in our economic future” (emphasis added).²

President Bush set forth essentially the same supply-side rationale for his tax-cutting program. On numerous occasions, he justified cutting the top marginal rate in order to enhance incentives for investment or, in his usual phrase, capital formation. To cite just a few examples:

But I want Congress to also understand that it’s not only important to drop the bottom rate, it’s important to drop the top rate as well. By dropping the top rate, we encourage growth, capital formation and the entrepreneurial spirit.

When we cut that top rate from 39.6 percent to 33 percent, we’re saying a loud and clear message that the entrepreneurial spirit will be reinvigorated as we head into the 21st century. It’s a way to pass capital formation in the small business sector in America. And it’s the right thing to do.

When we cut individual tax rates, we are stimulating capital formation in the small business sector of America. (emphasis added)³
The supply-side argument cannot be sustained purely on theoretical grounds. The claim is subject to empirical factual analysis of the historical record to establish its credibility or lack of credibility. Given the centrality of this argument to the debate over fiscal policy, it is worth asking what empirical evidence exists for the supply-side theory that low top marginal income tax rates increase rates of investment, employment, and economic growth.

A review of the literature shows empirical evidence supporting the supply-side claim to be sparse to nonexistent. Surprisingly enough, a pair of studies by the leading supply-side theorist, Martin Feldstein, and Douglas Elmendorf found virtually no net growth benefit from the Reagan supply-side marginal rate cuts of 1981. Feldstein and Elmendorf noted, “The rapid expansion of a nominal GNP [during the Reagan-era expansion of the 1980s] can be explained by monetary policy without any reference to changes in fiscal and tax policy.” In addition, Feldstein and Elmendorf explicitly ruled out that supply-side tax incentives were a factor in the recovery: “We also find no support for the proposition that the recovery reflected an increase in the supply of labor induced by the reduction in personal marginal tax rates.” The verdict of leading supply-side economists on the first supply-side experiment, in other words, found no empirical evidence to support a direct relationship between marginal tax rate cuts and growth in employment or GDP.¹

**The Key Policy Questions**

Does a low top marginal tax rate increase the rate of real GDP growth? The straightforward way to answer this question would be to examine actual rates of real GDP growth in the years with
low top marginal tax rates. If low top marginal income tax rates are said to increase growth, then it logically follows that we should see higher rates of real GDP growth in periods when the top marginal income tax rate is low. For policymakers, this would be decisive evidence and arguably the only evidence of practical merit. If low top marginal income tax rates have not been associated with high rates of growth in the past, then it hardly seems likely that cuts in the top marginal tax rate will produce high rates of growth in the present or future, and the supply-side case for enacting such cuts cannot be accepted as supported by historical data.

In recent years, the study most commonly cited by supply-side economists in support of the presumed growth effects of their tax-cutting program is by Eric Engen and Jonathan Skinner. For example, in arguing for making the Bush administration tax cuts permanent, Bush CEA member Harvey S. Rosen cited estimates from the Engen and Skinner article as the main support for his claim that continued low marginal income tax rates increase growth. Similarly, in a *Wall Street Journal* op-ed column backing the Bush supply-side tax policy, Hubbard cited Engen and Skinner as main evidence that large tax burdens reduce growth.5

A more careful look at the data presented by Engen and Skinner, in fact, reveals little, if any, factual support for the supply-side argument. Engen and Skinner attempted a straightforward approach to the question, examining rates of growth in the six years following the Kennedy–Johnson tax cuts of 1964 (1964–69) and the seven years following the Reagan tax cuts of 1982 (1983–89). Both tax cuts involved across-the-board reductions in marginal income tax rates, including significant cuts in the top marginal rate.

Engen and Skinner focused mainly on the years follow-
ing the two major tax cuts. According to Engen and Skinner, “The time-series correlation between marginal tax rates and growth rates yields a decidedly mixed picture; some decades were correlated positively and others negatively.” Suffice it to say that Engen and Skinner acknowledge “the uncertainty inherent in nearly every parameter used in [their] calculations.”

In the end, Engen’s and Skinner’s evidence for a growth effect from a cut in marginal tax rates is far more speculative, and the predicted growth effect much less robust, than one would imagine from the frequent citation of their study by supporters of the supply-side theory. Certainly, the carefully hedged Engen and Skinner study provides little substantiation for the sweeping generalizations that are prevalent in the supply-side arguments made by politicians for lowering the top marginal tax rate.

Marginal Tax Rates and Investment

The failure of the Engen and Skinner study to provide factual support for the supply-siders’ overall claim that cuts in the top marginal personal income tax rate increase investment, hiring, and real GDP brings us back to their theoretical claim. The primary mechanism by which supply-side theorists predict increased GDP growth from cuts in the top marginal income tax rate has to do with investment decisions by entrepreneurs. In 2004, the combined Bush tax cuts put an estimated additional $69 billion in the hands of high-income taxpayers (those with an Adjusted Gross Income of $100,000 or more), compared to the amount these taxpayers would have paid under pre–Bush administration tax law. Supply-siders claim that such changes in the tax laws cause a substantial increase in entrepreneurial investment by these taxpayers. This concept clearly lay behind
the statement by President Bush defending cuts in the top marginal rate on grounds they would increase investment by small businesses: “Most small businesses are sole proprietorships, or limited partnerships, or subchapter S corporations, which means that they pay tax at the individual income tax rate. And so, therefore, when you accelerate rate cuts, you’re really accelerating capital to be invested by small businesses.” Supply-side theorists base this case on a single empirical study, by Robert Carroll et al., of Internal Revenue Service data on the tax returns of a few thousand taxpayers who filed Schedule Cs (sole proprietorship) in both 1985 and 1988, before and after the Reagan Tax Reform Act of 1986, which enacted a major cut in top marginal income tax rates. For these taxpayers, business gains or losses are directly passed through to the business owner’s Adjusted Gross Income and taxed at individual income tax rates. The supply-siders’ theoretical argument is that when a reduction in the top marginal individual income tax rate puts more money into the hands of business owners, they use this money to substantially increase investment in their businesses.

Rosen cited the Carroll et al. study (of which he was a coauthor) in arguing that lowering top marginal rates increases investment by entrepreneurs—a major reason he presented for making the Bush tax cuts permanent. Hubbard cited the same study in his testimony before Congress as CEA chairman, urging Congress to approve the first Bush tax cuts.

But the study they cite does not support the supply-siders’ conclusions. Carroll and his colleagues analyzed the returns of a small sample of taxpayers who paid personal income taxes on their profits or losses rather than corporate taxes. Between 1985 and 1988, the Tax Reform Act of 1986 reduced the top marginal personal income tax rate from 50 per-
cent to 28 percent. The authors argued that the lower top marginal tax rate increased investment by these taxpayers in their entrepreneurial businesses.

This conclusion requires close scrutiny. First, the inferences drawn by Carroll et al. from their own data seem at best questionable. The analysis focused on a tiny sample of Schedule C filers. Of some 19,255 tax returns examined, only 3,480 taxpayers filed Schedule Cs in both 1985 and 1988 and therefore fit the criteria of the study. Notably, of this small sample of 3,480 the vast majority (80 percent) failed to make an investment in at least one of the two years. Even more striking, in 1988, after the substantial top marginal tax rate cut of 1986, the small percentage of taxpayers in the Carroll et al. sample who made any investment in their businesses did not increase overall, but actually declined—a critical fact on which the authors fail to comment. In addition, among high-income business owners (those who most directly benefited from the cut in the top marginal rate) the percentage who made investments in their businesses actually declined from 45 percent in 1985 to 40 percent in 1988. This hardly adds up to a robust case for the proposition that cuts in the top marginal income tax rate increase entrepreneurial business investment.

The Carroll et al. data on hiring yielded broadly similar results. Between 1985 and 1988, the percentage of high-income business owners in their study who had any employees actually declined, from 43 percent in 1985 to 42 percent in 1988.

It is surprising that small business behavior has been a centerpiece of the supply-side case. We should consider what a relatively small pool of taxpayers these high-income “entrepreneurs” represent. According to Internal Revenue Service estimates for 2001, the vast majority of high-income taxpayers who benefited from the 2001–03 cuts in the top marginal rate
(roughly 70 percent) owned no small business entity. Even if the data of the Carroll et al. study had supported the conclusions the authors draw about small business investments, cuts in the top marginal income tax rate would be a very blunt and inefficient instrument for encouraging total business investment or employment in the economy as a whole, since the benefit of this personal income tax cut goes mostly to taxpayers who do not own small businesses.

Carroll et al. acknowledge that individual business owners account for a small fraction—about 10 percent—of total business investment in the U.S. economy. This figure suggests that even a substantial increase in investment by individual business owners would have comparatively little impact on overall levels of business investment in the economy. For example, a 10 percent increase in investment by individual business owners, which would represent a substantial increase, would translate into a mere 1 percent increase in total investment in the economy.

Given these realities, we would expect to see little effect on investment or hiring from cuts in the top marginal income tax rate, and this indeed proves to be the case. The more closely one scrutinizes the “large body of evidence” that the supply-siders claim supports their key arguments, the more the cited factual evidence for supply-side contentions turns to sand.

Toward a Straightforward Assessment

It is time to return to the straightforward analysis that Engen and Skinner partially attempted and then rejected in the face of what they concluded to be “mixed” results. The straightforward policy claim of supply-side theorists is that a low top marginal income tax rate leads to higher rates of investment,
employment, and GDP growth. If this is indeed the case, then the historical record of U.S. economic performance should yield evidence of this pattern.

We can approach this question in a more definitive way than Engen and Skinner by greatly expanding the time-series data under examination. Engen and Skinner focused their analysis primarily on two small sets of time-series data, the six years following the Kennedy–Johnson tax cuts and the seven years following the Reagan tax cuts (using the two years preceding each episode as a baseline). A more complete data set from the post–World War II period can provide more comprehensive results.

To test the supply-side theory I examined the interrelationship of key economic indicators for the fifty-four years from 1951 to 2004 (see appendix for detailed data). My empirical approach divided the fifty-four years into three equal groupings ranked best performance, middle performance, and worst performance for each of the following variables:

- Real GDP growth
- Real growth in personal consumption expenditures
- Real growth in gross nonresidential fixed investment
- Employment growth
- Unemployment rate

Table 1 summarizes the performance of the U.S. economy in the eighteen years of this fifty-four-year period when the top marginal income tax rate was lowest. It shows the number of these years when the economy had “best,” “middle,”
or “worst” performance levels on (1) real (noninflationary) GDP growth, (2) employment growth, (3) the unemployment rate, and (4) real (noninflationary) growth in business investment (gross nonresidential fixed investment).

The most critical supply-side argument deals with the relationship between low top marginal income tax rates and real growth in GDP. Of the eighteen years in which the top marginal income tax rate was lowest, only two were also in the group of eighteen years with the highest real GDP growth.

Supply-side economists have argued that a low top marginal tax rate would lead to high growth in employment and a low unemployment rate. Yet of the eighteen years in which top marginal tax rates were lowest, only two were also in the group of eighteen years with the highest employment growth. Also, of the eighteen years in which top marginal tax rates were lowest, only five were also in the group of eighteen years with the lowest unemployment rate.

The main mechanism by which a low top marginal income tax rate is said to increase economic growth is by encouraging increased business investment. Yet of the eighteen years in which the top marginal tax rate was lowest, only seven were also in the group of eighteen years with the highest real growth of business investment. Notably, six out of these seven years occurred during the period from 1994 through 1999, immediately after the top marginal income tax rate was increased under President Clinton in 1993, from 31.0 percent to 40.8 percent (see appendix).

In any given year, exogenous conditions may have contributed to high or low performance on one or more of the major economic variables. But if the supply-side claims were valid, one would expect to see some reflection of the associa-
tion between low top marginal income tax rates and high performance on the other parameters over a historical sample covering fifty-four years. The data yield no such pattern.

Demand-Side Views of Taxation

What of the merits of the demand-side model? At the core of modern demand-side economics is the argument that a main driver of growth in the American economy is consumer demand. Since consumer spending comprises two-thirds of the American economy, it is obvious that a substantial increase in consumer spending is likely to produce a substantial increase in GDP.

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<th>Table 1</th>
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<td>Economic Performance in the Eighteen Years With the Lowest Top Marginal Income Tax Rate*</td>
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<th>Years With Lowest Top Marginal Income Tax Rates</th>
<th>Real GDP Growth</th>
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<th>Real Investment Growth**</th>
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<tr>
<td>Best Performance</td>
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<td>Middle Performance</td>
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<td>Worst Performance</td>
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*Top marginal tax rate of 41 percent or less.

**Real growth in gross nonresidential fixed investment.

Demand-siders argue that while levels of business investment may vary substantially from year to year, consumption is the principal factor that drives the business cycle. As the late Nobel laureate economist James Tobin wrote, “Economy-wide recessions and booms reflect fluctuations in aggregate demand rather than in the economy’s productive capacity.” Demand-side policies, therefore, “work by stimulating or discouraging spending on goods and services.”¹¹ A demand-side stimulus to the economy can be applied via either fiscal policy (reducing taxes and/or increasing government spending) or monetary policy (reducing interest rates and increasing the supply of money). In either case, the focus is on producing an increased overall demand for goods and services within the economy.

For demand-siders, the legitimate economic purpose for tax cuts at a time of economic downturn is “to stimulate the economy by putting more money in the pockets of consumers.” The latter language comes from a statement signed by one hundred economists, including seven Nobel laureates, critiquing the Bush administration’s supply-side tax cut proposals. In characteristic demand-side terms, the statement described the Bush supply-side tax cuts as “too large, too skewed to the wealthy, and [arriving] too late to head off a recession.” The demand-side economists’ 2001 statement called for a fundamentally different approach: “Instead of an ill-conceived tax cut, the federal government should use this year’s surplus to finance a temporary, one-time tax cut or ‘dividend.’ We should send a sizeable check this summer to every American, providing the immediate help the faltering economy needs. Compared with the President’s tax cut proposal, a temporary dividend would be more equitable, more efficient, and more appropriately targeted at the economic problem.”¹²
Behind this proposal was the core demand-side view that personal consumption, the major component of aggregate demand, is a main driver not only of GDP growth, but also of growth in business investment and employment. At the core of the demand-side approach is an understanding that risk-averse business managers’ investment and hiring behavior respond primarily to increased demand for their products and services. Their principal incentive to produce more is an increase in demand for the product. To attempt to stimulate business investment in the absence of this incentive is, in effect, to “push on a string.”

Note that President Bush and his economic team also agreed with the need for a consumer-based economic stimulus in his first term. Part of the announced rationale for the 2001 and 2003 tax cuts was to expand aggregate demand so as to help the economy recover from recession: and indeed tax rates were cut across the board to increase aggregate demand. At the same time, interest rates were cut substantially by the Federal Reserve to provide a monetary stimulus to the economy. The monetary policies of Alan Greenspan, chairman of the Fed, supported consumer demand through low mortgage rates, which enabled up to 80 percent of households to increase their “aggregate demand” by borrowing on the increased value of their homes. Indeed, this demand-side support was undoubtedly the major factor in moderating the recession of 2001–03.

The Bush administration justified cuts in the top marginal rate not on demand-side, but on supply-side grounds, as a means to increase business investment, which would result in increased growth in employment and GDP. Where Bush and the demand-siders differed was on three counts: The demand-siders rejected the supply-side theory that supply creates demand—the notion that, “If you build it, they will come.” The demand-siders objected to the substantial cuts in
the top marginal rate because they believed these cuts would drain the Treasury of billions in needed revenue in order to give an unneeded windfall tax benefit to the richest taxpayers. The demand-siders objected to the permanence of the tax cuts, which were bound to result in continuing large federal deficits. The demand-siders who signed the 2001 statement believed it was possible to stimulate consumption and aggregate demand via a temporary tax cut for all Americans rather than a permanent structural change in the tax code favoring the wealthiest segment of society.

Empirical Data for the Demand-Side Model

Whereas the data for the fifty-four years between 1951 and 2004 offer no support for the supply-side claim that a low top marginal tax rate is correlated with high growth in investment, employment, and GDP, if we examine the data through the opposite end of the telescope—and analyze economic performance from a demand-side rather than a supply-side perspective—a different pattern emerges. Data from the fifty-four years between 1951 and 2004 provide ample historical evidence for the core assumption of the demand-side model—namely, that high real growth in consumption is strongly associated with high performance of the most important economic growth variables.

First, consider real growth in GDP. The relationship between high real growth in personal consumption expenditures and high real growth in GDP is to be expected; indeed it is almost axiomatic. Since consumption amounts to about two-thirds of GDP, increases in consumption and GDP tend to go together. Of the eighteen years in which real growth in personal consumption expenditures were at their highest level, fifteen were also in the group of eighteen years with the highest real GDP growth, as shown in table 2.
Moreover, as table 2 shows, increased real growth in consumption was strongly associated not only with real GDP growth, but also with other positive economic indicators, including employment growth and increased real growth in business investment.

The data show a strong association between growth in personal consumption expenditures and growth in employment. Of the eighteen years in which growth in personal consumption expenditures was at its highest level, eleven were also in the group of eighteen years with the highest employment growth. The data show a similar relationship between high real growth in consumption and a low unemployment rate. Of the eighteen years with the highest growth in personal

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*Real growth in gross nonresidential fixed investment.
consumption expenditures, nine were also in the group of eighteen years with the lowest unemployment rate.

Finally, while the fifty-four-year record shows little association between low top marginal income tax rates and high rates of business investment, the data do yield a strong association between high growth in consumption and high growth in business investment. Of the eighteen years in which real growth in personal consumption expenditures was at its highest level, twelve were also in the group of eighteen years with the highest real growth in business investment.

Figure 1 shows the differences between demand-side and supply-side perspectives with respect to the data on the key variables in the analysis.

Demand-Side vs. Supply-Side Tax Cuts in Practice

The data on economic growth in the United States between 1951 and 2004 support the demand-side view that high personal consumption expenditures have a strong relationship to the performance of the economy. By contrast the supply-side view that low top marginal rates are directly related to economic growth is not supported by the data. To see how the two approaches worked out in specific periods, it is of additional value to examine more closely the impact of the three major tax reduction programs enacted during the period: the Kennedy–Johnson demand-side tax cuts of 1964–65, the Reagan supply-side tax cuts of 1982, 1987, and 1988, and the Bush supply-side tax cuts of 2001–03.

The Kennedy–Johnson tax cuts of 1964–65 (proposed by President Kennedy and enacted under President Johnson) were designed on demand-side premises. Supply-side economists have sometimes cited the Kennedy tax cut as a precedent for
the supply-side program because it included a reduction of the top marginal income tax rate from 87 percent to 70 percent. While the Kennedy tax cut did include a modest reduction in the top marginal rate, the philosophy behind the Kennedy tax cut was clearly demand-side in nature. The Kennedy economic team, comprising leading Keynesian economists of the day, explicitly aimed to expand aggregate demand. That is, they sought

to put more money in the hands of consumers, whose spending would then stimulate higher GDP growth and stronger employment. The demand-side nature of the program can be seen in the structure of the tax reduction. The bulk of the Kennedy tax cut went to middle- and lower-income taxpayers. *Nearly 60 percent of the Kennedy tax cut went to taxpayers in the lower 85 percent of the income distribution,* according to contemporary estimates by the U.S. Congress’s Joint Committee on Internal Revenue Taxation.\(^{14}\)

By contrast, the Reagan tax cuts implemented in 1982, 1987, and 1988 and the Bush tax cuts fully implemented in 2003 were largely focused on the supply-side objective of reducing the top marginal rate paid by top-bracket taxpayers. The Reagan and Bush tax cuts put more money in the hands of taxpayers with the highest incomes. According to an analysis by the Congressional Budget Office, *half of Reagan’s tax cut in 1982 went to households in the top 17.5 percent of the income distribution; the vast majority of households (82.5 percent) split the other half.* And Reagan’s further tax-cutting program in 1987 and 1988 granted substantial additional reductions in the taxes paid by top-bracket taxpayers. The Bush tax cuts were targeted even more directly to the upper end of the income scale. Bush’s cuts not only reduced the top marginal tax rate, but also substantially reduced the rates paid on dividends, capital gains, and estate taxes. By 2004, according to the Tax Policy Center, *over half (57.5 percent) of the combined Bush tax cuts went to taxpayers with the top 12.1 percent of incomes; the remainder of the tax cut (42.5 percent) was divided among the lower 87.9 percent of households.*\(^{15}\)

The data in figure 2 show that the Kennedy demand-side tax cuts in 1964 and 1965 were clearly associated with stronger performance on the major economic variables than were the
Figure 2. Comparing Economic Growth Following the Kennedy Demand-Side Tax Cuts versus the Reagan and Bush Supply-Side Tax Cuts in the Years They Went Into Effect. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts; U.S. Department of Labor, Bureau of Labor Statistics; author’s calculations (see appendix).

The economic growth immediately following the Kennedy–Johnson demand-side tax cut illustrates what economists sometimes call a virtuous cycle. In 1965, the year the tax cut was fully implemented, personal consumption expenditures grew by a strong 6.3 percent in real terms, and business investment (gross nonresidential fixed investment) grew by a strong 17.4 percent in real terms, accompanied by strong growth in employment. By contrast, there was little evidence of a virtuous cycle in operation in the years of the Reagan and Bush supply-side tax cuts. Growth in the centerpiece of the supply-side program—business investment—was typically in the low to middle range in the years of the supply-side tax cuts. This relatively weak investment growth was accompanied by lackluster growth in GDP and employment.

From a demand-side perspective, a case could be made that the Reagan and Bush tax cuts did not sufficiently increase aggregate demand because they put less than half of the tax cut money into the hands of the middle- and lower-income consumers who were most likely to spend it. Growth in personal consumption was typically in the low to middle range in the year of each Reagan and Bush supply-side cut, while growth in personal consumption expenditures was in the top range in the two years of the Kennedy demand-side tax cuts. Moreover, GDP growth in each Kennedy tax cut year was in the highest range, while GDP growth in the year of each Reagan and Bush cut was invariably in the low to middle range.

What if one assumes that there was a lag in the immediate economic effects of the tax cuts and that the impact was not fully felt until the year following the enactment of the cuts? The data in figure 3 show a similar demand-side versus supply-
Figure 3. Comparing Economic Growth Following the Kennedy Demand-Side Tax Cuts versus the Reagan and Bush Supply-Side Tax Cuts in the Years Immediately Following the Years They Went Into Effect. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts; U.S. Department of Labor, Bureau of Labor Statistics; author’s calculations (see appendix).
side pattern in the follow-on years with regard to GDP growth, consumption growth, and investment growth.\textsuperscript{16}

In short, the historical record of the performance of the American economy from 1951 through 2004 provides little to no support for the supply-side economists’ claim that cuts in the top marginal income tax rate caused improved performance on the key economic parameters of GDP growth, employment growth, and investment growth. By contrast, substantial support exists for the demand-side view that high personal consumption expenditures (the largest component of aggregate demand) are associated with high growth in GDP, employment, and investment.

Nor do historical data from the American economy support the oft-repeated supply-side claim that the very size of government imposes a drag on economic growth. Supply-siders have argued that virtually every dollar the government takes in has a “dead weight” effect in reducing GDP growth. Cutting the size of government has been a major supply-side goal since the time of President Reagan. Supply-side tax cuts were intended to force government spending cuts. Reagan’s budget director David Stockman described the strategy as one of “starving the beast.” “The surest way to bust this economy,” candidate George W. Bush said in 2000, “is to increase the role and the size of the federal government.” In 2001 Bush told reporters he intended his tax cuts to serve as a “fiscal straitjacket” for Congress to reduce the size of government and thereby increase economic growth.\textsuperscript{17}

Yet the American economy has actually grown faster in the era of “larger government” than it did in the era of “smaller government.” There is little to no empirical support for the supply-side claim that a lower overall tax burden (taxes as a percentage of GDP or GNP) goes hand in hand with higher
growth in GDP. An empirical study by William Gale and Samara Potter examined the federal tax burden, top income tax rate, federal spending as a percent of GDP, and average per capita GDP growth rates for long periods in the nineteenth and twentieth centuries. They found no consistent correlation between low taxes and per capita GDP growth. In particular, they note that the period 1870–1912, when there was no income tax, had the same average per capita GDP growth (2.2 percent) as the period 1947–99, when there were substantial income taxes.\(^{18}\)

Moreover, from 1890 through 1940, when federal outlays averaged just 5 percent of GNP, real GNP growth averaged 3.4 percent per year, while unemployment averaged 8.7 percent per year. From 1941 through 2004, when federal outlays averaged 20 percent of GNP, real GNP growth averaged 3.8 percent annually, while unemployment averaged just 5.4 percent a year. Not only has growth been somewhat greater in the larger government era; the economy has shown more stability in employment than in the years of smaller government.

Nor does the size of government necessarily tell us anything about the kind of role that government may play in the economy. Larger government does not have to be overly intrusive government. To be sure, highly bureaucratic command-and-control-style regulation can inhibit business activity and negatively affect economic growth. But the choice we face is not one between command-and-control government and as little government as possible. History has shown that government has often found nonbureaucratic methods of accomplishing major economic and social objectives. Through programs and policies such as Social Security, unemployment insurance, the GI Bill, and federal tax policies and loan guarantees to promote widespread home ownership, the federal government has managed to accomplish large economic and social objectives with a minimum of bureaucratic interference in the economy. In re-
cent decades, government agencies have found less intrusive, less bureaucratic methods of achieving socially useful objectives. The size of government tells us nothing about the wisdom of government policies. To the degree that larger government chooses smart, nonbureaucratic policies to accomplish society’s shared objectives, its role in the economy can be quite constructive.

Summary

The data analyzed in this chapter raise serious questions about the empirical basis for the supply-side theory and particularly about the central—and controversial—supply-side contention that cuts in the top marginal income tax rate bring substantial economic benefits. Supply-side economists and policy advocates have cited a body of empirical literature that provides little, if any, support for their argument. Contrary to the references to empirical data in the public statements of supply-siders, there is little specific evidence in the literature they cite of an association between low top marginal income tax rates per se and high growth in GDP. Indeed, even one of the leading supply-side theorists, Martin Feldstein, concluded that expansion of nominal GDP in the two years following the 1981 Reagan supply-side tax cuts “can be explained by monetary policy without any reference to changes in fiscal and tax policy.”

The study cited by supply-siders to support the argument that a reduction in the top rate results in increased overall business investment because of incentive effects on entrepreneurs provides data that contradict such a conclusion. The paper reports that the small number of individual business owners who pay taxes on business income at the personal income tax rate account for only about 10 percent of total business investment. Given these data, the theoretical argument
that marginal rate cuts for these taxpayers can substantially increase total business investment falls by the wayside.

Most important, the new empirical analysis of the performance of the U.S. economy over the fifty-four years from 1951 to 2004 presented here finds no association between low top marginal personal income tax rates and high real growth of GDP or investment or employment. By contrast, the analysis finds a substantial association of demand-side increases in real growth in personal consumption expenditures with high growth in GDP, investment, and employment.

The supply-siders’ subsidiary claim that there is substantial evidence for a link between high GDP growth and a lower overall tax burden (that is, overall taxes as a percentage of GDP) is qualified by numerous caveats in their cited literature and remains highly speculative in nature. (This is the supposed economic rationale for the starve-the-beast strategy of cutting taxes to reduce the size of government.) But as we have seen, historical data on the comparative performance of the U.S. economy in eras of smaller government versus larger government do not support this claim.

Supply-siders sometimes argue that economic growth, though unimpressive following supply-side tax cuts, might have been lower without them. But neither the existing literature nor the historical record provides substantial evidence to support this theory. The central claim of the supply-side school—that low top marginal income tax rates lead to increased investment, employment, and GDP growth—is not supported by the empirical evidence. Given that cuts in the top marginal income tax rate have also increased income inequality—and that supply-side tax cuts have resulted in large federal deficits—history’s verdict on supply-side tax policy is likely to be unfavorable.
Chapter IX
The Way Forward

Addressing the Economic Questions

Two opposing ideas compete today as they have through much of our history for the support of all Americans. One is the American Dream, inspired by President Lincoln and carried forward by Presidents Theodore Roosevelt, Woodrow Wilson, Franklin Roosevelt, and Bill Clinton. The other is the Gospel of Wealth, developed in the second half of the nineteenth century and carried forward in the twentieth century by Presidents Harding, Coolidge, and Hoover and more recently by Presidents Ronald Reagan and George W. Bush. The implementation of one or the other of these ideas has had and will have major economic, moral, and political consequences for the future of American democracy.

Early in the twenty-first century, much of the debate between the two ideas has focused on the economic consequences of supply-side economic policies that are central to modern proponents of the Gospel of Wealth versus demand-side economic policies that are central to modern proponents of the American Dream.
The findings of my empirical study, discussed in chapter 8, should put to rest the notion that there is an inherent conflict between economic and tax policies that spur economic growth and policies that contribute to a fair and balanced democratic society. The win–win conclusion is, demand-side economic policies not only increase the ability of all Americans to improve their living standards, but also provide positive support for the economic, moral, and political objectives of American democracy.

Disregarding the evidence that demand-side economic policies provide the best support for our economy, the administration of George W. Bush has taken the strongest steps in more than fifty years to change the direction of economic policy to Gospel of Wealth, supply-side programs. During the Bush administration, there has been a growing acceptance of the idea that it is fair for some Americans to start life with inherited millions, while others begin dirt-poor. Under Bush, America has been evolving into what the economists Robert H. Frank and Philip J. Cook called a “winner-take-all society.” The top 20 percent of households are taking in half the income of the entire nation. Salaries of chief executive officers are over five hundred times those of the ordinary production workers in their corporations. Investment bankers and business executives collect tens of millions of dollars in bonuses and severance and retirement packages, while American soldiers who risk their lives to ensure the safety of prosperous and poor alike can barely make ends meet.

George W. Bush’s Gospel of Wealth policies have widened the inequality of income between the richest Americans and all other Americans. In 2003, the 5 percent of American households with the highest incomes had a 22 percent larger share of total national income than in 1967, while at the lower end of
the income distribution, 60 percent of American households had a 16 percent smaller share. Under present tax policies, the five to six million households in the top 5 percent income group receive an increasingly larger share of America’s national income, while ninety million middle- and lower-income households—representing 80 percent of all households—are finding it increasingly difficult to maintain their standard of living except by borrowing on their homes, their credit cards, and any other means available.

President Bush, meanwhile, has deliberately increased the winners’ share of the takings, cutting top marginal income tax rates, reducing taxes on dividends and capital gains, and even undertaking to eliminate the estate tax—a measure self-consciously designed by Progressive Era political leaders to prevent America from degenerating from a democracy of political equals into an aristocracy of wealth.

In contrast to the supply-side winner-take-all tax structure, a progressive tax structure based on demand-side principles would help to sustain virtuous economic cycles in which steadily increasing consumption leads to continuing growth in production and increasing employment income for most Americans, which then sustains increasing growth in GDP. Henry

### Table 3

<table>
<thead>
<tr>
<th>Income Level</th>
<th>1967</th>
<th>2003</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5%</td>
<td>17.5</td>
<td>21.4</td>
<td>22</td>
</tr>
<tr>
<td>Next 15%</td>
<td>26.3</td>
<td>28.4</td>
<td>8</td>
</tr>
<tr>
<td>Next 20%</td>
<td>24.2</td>
<td>23.4</td>
<td>(5)</td>
</tr>
<tr>
<td>Lowest 60%</td>
<td>32.0</td>
<td>26.8</td>
<td>(16)</td>
</tr>
</tbody>
</table>

*Source: U.S. Census Bureau*
Ford succinctly summarized the essential understanding of demand-side virtuous economic cycles when he said, “If you don’t pay the people enough money, they can’t buy the cars.”

But there is no simplistic approach to successful economic policy. There is always a substantial risk that either incorrect monetary or misguided fiscal policies can produce negative economic results. The fiscal policies followed by Lyndon Johnson and his successors in the late 1960s and the 1970s produced an economic boom followed by runaway inflation. The restrictive monetary policies of the early 1930s deepened the Great Depression. By contrast, properly managed monetary and fiscal policies can achieve the desired positive goals.

The data for the fifty-four years from 1951 to 2004 analyzed in chapter 8 indicate that demand-side fiscal policies produced the healthy growth of our middle-class economy during the 1950s and early 1960s. And intelligent monetary policies during the 1980s and 1990s were the basis of a healthy, consistent growth of the economy.

In contrast to the positive evidence supporting properly executed monetary policies and demand-side fiscal policies, there is no evidence that supply-side tax cuts for the wealthiest taxpayers during the Reagan and George W. Bush presidencies actually increased investment and growth. Neither empirical research nor the historical experience of supply-side tax cuts provides evidence for this claim. Indeed, the evidence is that very little of the money put in the hands of the wealthiest taxpayers ended up as investment in their businesses or sustained growth in the economy. Moreover, the distributional effects of the Bush tax cuts provided a windfall for the rich while eliminating revenues that are needed, first, to pay the government’s bills, second, to begin to address the anticipated problems of Social Security and Medicare for an aging population, and,
third, to provide the federal government with the resources needed to deal with new national defense obligations and natural disasters such as Hurricanes Rita and Katrina.

The Future of American Democracy

It is fortunate for the future of American democracy that the data supporting the economic growth case for demand-side economics are strong while there is no significant evidence to support supply-side economic policies. The additional benefit of demand-side economic policy that supports growth in personal consumption for all Americans is its contribution to a fairer and more stable American democratic society.

History teaches us that the future of any democracy depends on a thriving middle class. This is true in both an economic and a political sense. From the standpoint of economics, middle-class consumer spending is the primary engine of economic activity and growth. Sustaining the incomes—and therefore the spending—of the middle class is essential to sustaining the growth of the economy as a whole. It is the key to the virtuous economic cycle. From the standpoint of politics, in a democracy the existence of a large, vibrant middle class is crucial to political stability. The middle class acts as a buffer, softening the age-old struggle between the haves and the have-nots. It is through the middle-class dream that Americans come to share common aspirations—aspirations that help to mute the differences in wealth, culture, race, and ethnicity that might otherwise threaten to tear a democracy apart. To survive, a democracy must also be a community—a society bound by shared values.

From the standpoint of morality the public needs to believe that America operates on the principle of fairness. Ameri-
cans must view their government as pursuing policies that are fair to all citizens, and not hopelessly skewed to those who, by dint of their wealth, can command greatest control over government policy and the distribution of society’s resources. If, under the influence of supply-side economic policies, income inequality continues to grow, and America evolves from a middle-class society into an asymmetrical “hourglass economy”—with a few at the top, many at the bottom and ever fewer in the middle—it will be increasingly difficult to sustain the belief that Americans share a common destiny that outweighs the differences that divide us. The belief in fairness will wither, and with it the sense of democratic community.

Conclusion

This book has focused on the contrast between economic policies animated by the American Dream and policies animated by the Gospel of Wealth. What seems clear is that fulfilling the American Dream is a work in progress. Americans need to come together to genuinely meet the economic and noneconomic challenges before us.

In recent times we have witnessed an increasingly sharp break with the policies that forged American greatness and made the twentieth century, in Henry Luce’s famous phrase, “the American century.” Only a few years ago, the United States was the leader of a powerful and unified Western alliance. Today, as our enemies multiply, we are alienated, in one degree or another, from many of our old friends. Americans have always had some partisan differences, but for decades there was a strong consensus around a society that removed barriers to opportunity, provided a basic social safety net for the poor, and above all ensured that Americans who work hard and play
by the rules could maintain a decent middle-class standard of living, ultimately bettering their circumstances and creating new opportunities for their children.

All this is under challenge today. In foreign policy, there is a new commitment to the doctrine of preemptive war. In domestic policy, there is an increasing effort to move toward a winner-take-all model, in which the wealthiest households claim an ever-growing share of national income, while middle-class families struggle to make ends meet.

To build a future based on the American Dream, we need to remind ourselves that the American success story has always been about more than mere individualistic economic striving. America has succeeded because the nation came together at critical moments in our history to support common programs to serve the common good. These programs were informed by core values held in common by most Americans, values which were originally defined by the Declaration of Independence, the Constitution, and the Bill of Rights and have since been elaborated and sustained by our shared history. The values that define the American community include the belief that society should provide its citizens with equality of opportunity, material well-being, and the opportunity for individual self-fulfillment and that American society should operate on the principles of fairness, justice, and compassion. These values include the essential idea that the rights of citizens to the benefits of society must be accompanied by the assumption of responsibility for the good of society. We need to reexamine the premises of both current-day conservatism and current-day liberalism. We need to think through our policy challenges anew and to recover the historical balance between our admirable belief in individualism and our sense of community as a nation.
What kind of a nation are we? what kind of a nation do we seek to become? and what kind of world do we seek to create? Are we a nation always ready to defend ourselves, yet dedicated to principled action in the international realm? Are we still a people, as we once were, committed to economic opportunity for all and compassionate toward the least fortunate among us? or are we a society that now disproportionately rewards the big winners and leaves ordinary citizens to fend for themselves? Are we still the America of the great “American century” or are we being transformed into something quite different—no longer the strong and benevolent nation that once stood as a “shining city on a hill”?

The most disappointing feature of the current era has been the absence of a powerful vision—one that fully recognizes the importance of the American legacy. To date, efforts to design new programs for the future have largely focused on tactics rather than substance. They have been uninformed by a commanding vision—a larger idea of America of the kind that inspired us throughout American history. We must rekindle such a vision of America, if the American democracy we have come to know and love is to survive and prosper in the new century.

Fortunately, the basis for this vision exists in the values that are held in common by most Americans. In a recent book, *Uniting America: Restoring the Vital Center to American Democracy*, Daniel Yankelovich, the leading analyst of American public opinion, shows that the American public has not joined the politicians in their partisan divisiveness. A majority of Americans desire social cohesion and common ground based on pragmatism and compromise, patriotism, community and charity, child-centeredness, acceptance of diversity, and cooperation with other countries. Coupled with these values that
promote social cohesion are well-accepted beliefs in hard work and productivity, self-confidence, individualism, and religious beliefs. Yankelovich concludes that the values that unite us far outweigh any that divide us and can provide the basis for a future consistent with the American Dream.

A new commitment to the American Dream is the first step. Wise, consensus-based policy is the second step. Unit ing America engaged some of our most thoughtful experts to present consensus building solutions to our most important public policy issues. In separate compelling essays, they offer fresh insight into some of the most pressing problems that face us: Daniel Yankelovich on “Overcoming Polarization,” Francis Fukuyama on “The War on Terrorism,” Alan Wolfe on “Religion as Unifier and Divider,” Norton Garfinkle on “Economic Growth and the Values of American Democracy,” Tsung-mei Cheng and Uwe Reinhardt on “The Ethics of America’s Health Care Debate,” Will Marshall on “Social Security and Medicare Reform,” Amitai Etzioni on “The Fair Society,” and Thomas Mann on “Electoral System Reform,” among other contributors. These essays and the independent work of other dedicated public policy experts provide the basis for needed programs to fulfill the American dream.

The stakes are high. In a very few years, our once-revered nation has come to be perceived across the globe, by majorities in nearly every country surveyed, in a negative light. Our nation is now being described as unwilling to engage in alliances unless our allies agree to support our leadership without their input as to strategy or tactics. As a consequence, we are less able than in the past to forge successful alliances to deal with continuing and increasingly difficult issues beyond our shores.

At home, meanwhile, we witness an unremitting challenge to programs crafted over decades that helped to build
and sustain the middle-class basis of American society. From the 1930s through the 1960s, American political leaders of both parties shaped policies designed to extend economic opportunity, protect against economic insecurity, and above all to make a middle-class standard of living accessible to most Americans. These policies included a progressive income tax; Social Security; unemployment insurance; federal support for education in the form of the GI Bill, student loans, and vital millions for research; policies to foster widespread home ownership; and programs such as Medicare, Medicaid, and Food Stamps to provide a minimum hedge against sickness and hunger among the least fortunate members of our society. All these measures worked together to create the America we know: a dominantly middle-class society, with great opportunities for economic advancement, a proper measure of compassion for the least fortunate, and a shared American dream.

But now we face a contrasting doctrine that disparages the progressivity of the tax code, desires to change the firm commitment to Social Security, and views health care for the least fortunate among us as something our affluent society cannot afford. New tax cuts have transformed a multibillion-dollar federal surplus into multibillion-dollar deficits. And now the deficit has become a weapon “to starve the beast”—the new parlance for a comprehensive plan to undo the efforts by both parties, over many decades, to use government policies to sustain a fair, prosperous middle-class society. The belief that government has little responsibility to care for common needs, and the claim that government is largely incompetent to accomplish common purposes—such has become a major ideology of our time. Yet such assertions not only fly in the face of decades of historical experience during the great American
century: they also disarm and disable us as we face the challenges of the future.

*An extremely individualistic vision is precisely the wrong prescription for the foreign and domestic issues that loom before us.* In foreign affairs we are confronted by the continuing threat of a major terrorist attack, an unstable Middle East, emerging nuclear capabilities in hostile states such as Iran and North Korea, and a shift in the balance of power toward China—all while our military is strained almost to breaking by existing commitments. Coping with these foreign dangers—and especially the elusive international networks of terrorists—will require a statecraft that understands cooperation and appreciates the vital importance of close alliances. Supporting democracy in the rest of the world requires more than military might to change foreign regimes. And it requires more than building a “city on the hill,” to be admired and reproduced by other countries. Exporting democratic values is a worthy endeavor that can succeed only through carefully developed programs implemented by wise government leaders. Above all, these programs should be guided by the principle that success can be achieved only by using realistic means to achieve idealistic goals.

In the domestic arena, we confront depressed wage growth; a widening income divide between the rich and the rest of our citizens; and massive increases in debt at both the federal and household levels. We must also address the daunting challenge of an aging population; large unfunded liabilities for Social Security and especially Medicare; galloping health care cost inflation that threatens to bankrupt the federal and state budgets, making health care increasingly unaffordable for middle-class Americans and a growing burden on corporations. A
rethinking of current approaches to domestic policy is clearly in order. We need to overcome the historical forgetfulness that besets contemporary policy debate—the lack of appreciation for the vital role that well-crafted government policies have played in creating the America most of us grew up in. And we need to change the short-term focus of contemporary policy debate. To build a confident American democratic future, short-term, politically expedient policies must be replaced by wise and strategic long-term solutions. Addressing these domestic issues will require cooperative action of the kind that only effective government policy can provide.

One thing is clear: Americans must understand the profoundly different directions in which policies based on the Gospel of Wealth and policies based on the American Dream will take them. Political leaders seeking to serve the common good must reawaken our understanding of the true American Dream and remind us again of what Lincoln meant when he expressed the profound hope that “government of the people, by the people, for the people, shall not perish from the earth.”
Appendix

GDP, Consumption, Investment, Employment, Unemployment, and Marginal Tax Rates 1951–2004*

*Years have been divided into three 18-year groups, ranked BEST, MIDDLE, and WORST.

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP</th>
<th>% Real GDP Growth</th>
<th>Ranking of % Real GDP Growth</th>
<th>Personal Consumption Expenditures</th>
<th>% Real PCE Growth</th>
</tr>
</thead>
<tbody>
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<td>1951</td>
<td>339.3</td>
<td>7.7</td>
<td>BEST</td>
<td>208.5</td>
<td>1.6</td>
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<td>MIDDLE</td>
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<td>233.1</td>
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<td>2</td>
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<td>414.8</td>
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<tr>
<td>1956</td>
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<td>WORST</td>
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Notes

Introduction


Chapter 1.
The American Economic Vision


Chapter 2.

The Origins of the American Dream


2. Ibid., 4:168–69, 5:52.

3. Ibid., 4:438.


6. James Truslow Adams, *The Epic of America* (Boston: Little, Brown, 1932), 404: “But there has been also the American dream, that dream of a land in which life should be better and richer and fuller for every man, with opportunity for each according to his ability or achievement. It is a difficult dream for the European upper classes to interpret adequately, and too many of us ourselves have grown weary and mistrustful of it. It is not a dream of motor cars and high wages merely, but a dream of a social order in which each man and each woman shall be able to attain to the fullest stature of which they are innately capable, and be recognized by others for what they are, regardless of the fortuitous circumstances of birth or position.” Adams went on to write, “In a modern industrial State, an economic base is essential for all. We point with pride to our ‘national income,’ but the nation is only an aggregate of individual men and women, and when we turn from the single figure of total income to the incomes of individuals, we find a very marked injustice in its distribution. There is no reason why wealth, which is a social product, should not be more equitably controlled and distributed in the interests of society. . . . If [the American Dream] is to come true, those on top, financially, intellectually, or otherwise, have got to devote themselves
to the ‘Great Society,’ and those who are below in the scale have got to strive to rise, not merely economically, but culturally. . . . Lincoln was not great because he was born in a log cabin, but because he got out of it—that, because he rose above the poverty, ignorance, lack of ambition, shiftlessness of character, contentment with mean things and low aims which kept so many thousands in the huts where they were born.” Ibid., 410–11.


8. Ibid. 2:165–66.
9. Ibid. 1:53.
10. Ibid. 2:36–37.
11. Ibid. 2:137–38.
12. Ibid. 2:266.
15. Ibid., 59, 225–33.
16. Boritt, Lincoln, xxiv, 221.
19. Ibid., 2:126.
20. Boritt, Lincoln, 113. Interestingly, the reason Lincoln most admired the great African American leader Frederick Douglass was that, like Lincoln himself, Douglass embodied the “self-made” ethic. Douglass had struggled from nowhere to become one of the nation’s most eloquent politicians and prominent citizens. Lincoln remarked to an associate that “considering the condition from which Douglass rose, and the position to which he attained, he was . . . one of the most meritorious men in America.” Douglass, meanwhile, found in Lincoln “the first great man that I talked with in the United States, who in no single instance reminded me . . . of the difference of color.” Boritt, Lincoln, 174.
21. Ibid., 197.

Chapter 3.
The Gospel of Wealth


10. Ibid., 53, 57–58.

11. Ibid., 8.


17. Ibid., 210–11.


28. Ibid., 58, 62.
35. Ibid., 4–5.

Chapter 4.
The Age of Reform


20. Ibid., 47.

21. Ibid.


Chapter 5.
The Business of America Is Business


4. Ibid., 198.


16. Ibid., 1–3; for unemployment estimate, see *Historical Statistics of the United States*, 1:135.
17. Peter Temin, *Did Monetary Forces Cause the Great Depression?* (New York: W. W. Norton, 1976).


20. Later official estimates of unemployment by the Bureau of Labor Statistics, based on work by the scholar Stanley Lebergott, placed unemployment in 1942 at 4.7 percent. However, these estimates treated workers employed in federal public works programs as unemployed. When public works workers are treated as employed, the estimate is reduced from 4.7 to 3.1 percent. See Michael R. Darby, “Three-and-a-Half Million U.S. Employees Have Been Mislaid: Or, an Explanation for Unemployment, 1934–1941.” *Journal of Political Economy* 84, no. 1 (1976): 8, and also discussion in chapter 6 below.


### Chapter 6.

**The Renewal of the American Dream**


15. Ibid.  


37. Ibid., 120.


Chapter 7.

The New Gospel of Wealth


6. Ibid., 237–49.


15. For a detailed discussion of this literature, see chapter 8.


Chapter 8.
The Current Debate


10. Figures for gross nonresidential fixed investment provide a better index of the behavioral effect of tax policy changes than the net figures, which include depreciation. Gross figures reflect the actual amount of money invested in businesses in a given year.


16. The growth in investment in 2004 can best be understood as a response to the Bush administration’s 2004 one-year 50 percent “bonus depre-
ciation” tax deduction for all business investment by corporations and individuals. Corporate taxpaying entities that account for roughly 90 percent of all business investment in the economy were primarily responsible for the high rate of business investment in 2004. It would be hard to attribute this investment level to a response by pass-through business owners to the 2003 reduction in the top marginal personal income tax rate since these business owners account for only 10 percent of all business investment.


19. Employment during the period under study is best measured by growth in employment rather than by the unemployment rate. Employment growth is a directly measurable statistic. By contrast, the unemployment rate is derived by dividing the number of people employed by the number classified as being in the workforce (i.e., employed or “looking for work”). The unemployment rate can be an unreliable statistic. The number of people working or available for work can be misclassified as in the statistics for the Depression years or can be substantially affected by a change in the number of people who temporarily or permanently enter or drop out of the workforce. In some cases, such as the relatively weak economic period of January 2001–March 2006, the unemployment rate declined while employment growth was only 38,000 per month, substantially less than the 150,000 per month required to provide jobs for new entrants to the workforce. The anomaly can best be understood as a result of people dropping out of the workforce due to a decline in the number of available jobs. By contrast, in the relatively strong economic period 1993–2000 employment growth was substantially higher (240,000 per month) as new people entered the workforce in response to an increase in the number of available jobs.

Chapter 9.
The Way Forward

abolitionist movement, 41, 51
Ackley, Gardner, 138
activist government, 14, 37, 40, 44–46, 108, 118–22
Adams, Charles Francis, 51
Adams, Henry, 51
Adams, James Truslow, 29
Addams, Jane, 71
advertising, impact on economy, 91–93
aggregate demand: consumer demand and borrowing, 175–76; deficit spending programs, 112, 118; demand-side economics, 163, 176–77, 180; federal expenditures, 125–26; Keynesian economics, 6, 100–103, 131, 142; recessions, 125–26; supply-side economics, 183; tax cuts, 175–77
Altgeld, John Peter, 71
American Dream: concept, 206–16; economic policy, 194–200; Lincolnian ideal, 28–30, 52, 82–84; middle-class ideal, 12–13, 15–17; origins, 29–33; Wilsonianism, 82–84. See also demand-side economics; Lincoln, Abraham
American System, 34–36, 39–40, 45
Annie Kilburn (Howells), 75
Annual Economic Report, 122
antipoverty programs, 7, 135
Appalachian Regional Development Act (1965), 135
Aristotle, 21
Atlantic Monthly, 75
automobiles, 89, 90–93, 101–2
balanced budgets, 107, 111–12
Banking Act (1935), 115
banking industry, 34–35, 39, 45, 104–6, 114–15
Barro, Robert, 140
Bartlett, Bruce, 145
Bellamy, Edward, 70
Bill of Rights (Roosevelt), 119–20
Blaine, James G., 51
Boritt, Gabor, 45
Bryan, William Jennings, 73, 75, 79–80
Bryce, James, 50, 62
Buffett, Warren, 19
Bundy, McGeorge, 131
Bureau of Labor Statistics, 114
Burns, Arthur F., 126, 139
Bush, George H. W., 24, 150
capital formation, 159–60, 165, 169
Carnegie, Andrew, 15, 64–67, 95
Carroll, Robert, et al., study by, 169–71
Carter, Jimmy, 23, 139–43, 149
Cheng, Tsung-mei, 197
child labor, 55, 56, 71, 85, 116, 124
Civilian Conservation Corps, 114
Civil War, 42–43
Civil Works Administration, 114
class conflict, 72–73, 76, 82
Clay, Henry, 34–36, 38–40, 43–45
Clayton Antitrust Act (1914), 85
Cleveland, Grover, 51, 62
Clinton, William Jefferson, 2–3, 18, 23–24, 158–59
Collier’s, 77
Congressional Government (Wilson), 80–81
Cook, Philip J., 190
Coolidge, Calvin, 16, 95, 96
corporations, economic issues and, 47–48, 63, 76
corruption, 49, 51–52, 62, 74–75, 77
Cosmopolitan, 77
Council of Economic Advisers, 122
Cox, James M., 88
Crane, Stephen, 75
Curry, Leonard P., 45
Darwin, Charles, 53, 57–58
Daugherty, Harry, 97
deficit spending programs: impact on economic growth, 6–10, 24–25, 103; Johnson administration, 135–37; Kennedy administration, 131–34; Keynesian economics, 109, 111–12; neo-Keynesian economics, 128–29; Reagan administration, 145–47, 155; Roosevelt administration, 109, 111–12, 118; unemployment, 128–29
deflation, 142
also supply-side economics; top marginal income tax rate
Democratic Party, 39, 50, 51, 62, 72–73
democratic principles: future directions, 193–200; Jacksonian politics, 38–39; Lincolnian ideal, 28–29, 37, 44–46, 60; Social Darwinism, 60–67
Dickens, Charles, 56
Dillon, C. Douglas, 131
Douglas, Stephen, 41–42
Douglas, Frederick, 207

durable goods purchases, 92–93, 101–2

economic freedom. See economic opportunity

Economic Opportunity Act (1964), 135


free labor, 40, 42–44, 50–57, 83
free market economics, 14–15, 44–46, 52–67, 114. See also laissez-faire economics; supply-side economics
Frick, Henry Clay, 95
Friedman, Milton, 141–43, 152
Fukuyama, Francis, 197
Future of American Democracy Foundation, viii
Garfinkle, Norton, 197
General Motors Acceptance Corporation (GMAC), 90
General Motors Corporation (GM), 90–91
General Theory of Employment, Interest, and Money (Keynes), 100–101, 103, 109
George, Henry, 70
G.I. Bill, 120–21
Gilded Age politics, 49–67
Gladden, George Washington, 70
Glass-Steagall Banking Act (1933), 115
gold standard, 72, 104, 109–10
Goldwater, Barry, 132, 135, 149
Gordon, Kermit, 133
Gospel of Wealth, 15–17, 64–68, 88, 95, 194–200. See also Bush, George W.; Reagan, Ronald; supply-side economics
government involvement: business investments, 95–99; economic growth, 52–67; Jacksonian politics, 39;
Lincoln administration, 43–46;
Reagan administration, 153–56;
reform efforts, 69–70; Social Darwinism, 53, 56–67; supply-side economics, 8–10, 17; Whigism, 34–37.
See also regulation legislation
graduated income tax, 80, 84
Grant, Ulysses S., 49, 51
Great Society program, 7, 135, 137, 150
Great Stock Market Crash of 1929, 5, 99–102
Greenspan, Alan, 100, 110–11, 150, 176
Gross Domestic Product (GDP): Bush administration, 3; Clinton administration, 3; consumer demand and borrowing, 174–80; demand-side economics, 163, 176–88, 191; growth rate, 1, 3, 154–56, 166–74, 177–86;
Reagan administration, 153; Roosevelt administration, 112; supply-side economics, 164–74, 181–88; top marginal income tax rate, 166–74, 176–77, 180–88
Gross National Product (GNP):
Eisenhower administration, 123–25, 127; growth rate, 47, 123–25, 127, 134, 138, 140, 186; Johnson administration, 138; Kennedy administration, 132, 134; post–World War I decade, 89, 93, 103; Reagan administration, 166; Roosevelt administration, 112, 118
Hamilton, Alexander, 35
Hanna, Mark, 74
Harding, Warren G., 16, 88, 96
Hard Times (Dickens), 56
Hayes, Rutherford B., 71, 74
Heller, Walter, 133, 138
higher education, 120–21, 123
History of the Standard Oil Company (Tarbell), 77
Hobbes, Thomas, 57
Holmes, Oliver Wendell, Jr., 63–64
home ownership, 115, 127, 162. See also residential construction
Home Owners Loan Corporation, 115
Homestead Act, 45
Hoover, Herbert, 6, 16, 96, 105–6
Howells, William Dean, 70–71, 75
*How the Other Half Lives* (Riis), 75
Hubbard, R. Glenn, 165, 167, 169
Hull, Cordell, 84
Hull House, 71
Humphrey, Hubert, 132
Humphrey, William E., 96

ignorant proletariat, 53–54
immigrants, 48, 49, 54, 71
income tax. See taxation
inequality, as democratic principle, 60, 66–67
insider trading, 98
installment buying plans, 90–93, 98, 101
insurance programs, 113–17, 124–26
interest rates: Federal Reserve, 7, 100, 104, 110–11, 137–38, 143, 162, 176;
home equity borrowing, 162, 176
internal combustion engine, 89–90
internal improvement systems, 34–41, 45, 49, 62, 123
Interstate Commerce Act (1887), 69, 76
Interstate Highway System, 123

Jackson, Andrew, 38–39
James, Henry, 70
Johnson, Lyndon B., 7, 133–38, 192
judicial system, 63
*Jungle, The* (Sinclair), 77, 78

Kansas-Nebraska Act, 42
Kelley, Florence, 71
Kemp, Jack, 148, 149
Kennedy, John F., 129–33
Keynes, John Maynard: aggregate demand, 6, 100–103, 141–42; Roosevelt administration, 109;
Say’s Law, 93, 145; in *Time* magazine, 135
Keynesian economics, 6, 100–103, 121–28, 146. See also neo-Keynesian economics
Kristol, Irving, 146–47, 148, 149

labor force: immigrants, 48, 49, 54; job creation, 1–2; regulation legislation, 116–17; wages and income, 97, 116–17, 124; women in the workforce, 118; working conditions, 52–56, 63–64, 85, 116–17, 124. See also unemployment; unionization
labor movement. See unionization
Laffer, Arthur, 148
La Follette, Robert M., 80
laissez-faire economics, 14–15, 17, 52–67, 88, 96, 144–45
Lebergott, Stanley, 114
liberty, importance of, 37, 44, 119–20
living standards, 10–11, 89, 190–91, 195
Lloyd, Henry Demarest, 70, 75
*Lochner v. New York*, 63
Looking Backward from 2000–1887 (Bellamy), 70
Lynd, Robert and Helen, 92

machine bosses, 49, 52
macroeconomic issues, 109–12
Maggie: A Girl of the Streets (Crane), 75
Mann, Thomas, 197
manufacturing sector: activist government, 35–38, 40; federal expenditures, 49; free labor policies, 50–57; Great Depression, 106; growth rate, 47–48, 97; protective tariffs, 45; Supreme Court decisions, 63; survival of the fittest, 64–65. See also free labor; Robber Barons
Marshall, Will, 197
Martin, William McChesney, 131, 137–38
McClure’s, 77
McKim, James Miller, 51
McKinley, William, 71–75, 79
Meat Inspection Act (1908), 78
Medicare, 130, 150, 161, 198–99
Medicare Act (1965), 135
Mellon, Andrew W., 94, 95–96, 105
Mellon, Thomas, 95
middle-class society: economic vision, 12–13, 37–39; G.I. Bill, 120–21; growth rate, 7, 21–22; historical importance, 21–22, 32–33, 193; impact of economic policy on, 22–26, 159, 192–94, 198; inflation rates, 141; installment buying plans, 90–93, 101; living standards, 10–11, 89, 141, 190–91, 195; stagflation, 7–8; taxation, 8, 144, 161; Wilsonianism, 84. See also consumer demand and borrowing
military forces, 86–87, 118, 136–37, 199
Mill, John Stuart, 52
Miller, G. William, 139
misery index, 140
Missouri Compromise, 42
monetarism, 141–43, 152, 154–56
Monetary History of the United States, A (Friedman and Schwartz), 141 moneter policy, 103–6, 109–11, 141–43, 154–57, 162, 175, 192
Montgomery, David, 55
moral economic consequences, 5, 10, 17–18, 20–21, 193–94
Morgan, J. P., 110
Morrill Act, 45
mortgage debt, 93, 115
muckrakers, 77, 79
mugwumps, 50–57
Mundell, Robert, 148
Nation, 51, 55, 59–60, 70
National Banking Act, 45
national bank system, 34–35, 39, 45
National Defense Education Act (1958), 123
National Industrial Recovery Act (1933), 117
nationalism, 35–36
National Labor Relations Act (1935), 116
neoconservative policies, 144–51
neo-Keynesian economics, 128–29, 131–38, 141–43. See also Keynesian economics
New Deal, 108, 112–23, 130, 149–50
New Frontier, 130
Newton, Isaac, 57
Norquist, Grover, 161
Norris, Frank, 77
North American Review, 75
Norton, Charles Eliot, 51
Octopus, The (Norris), 77
Okun, Arthur, 139
Organization of Petroleum Exporting Countries (OPEC), 139
organized labor. See unionization
Origin of the Species, The (Darwin), 57–58
Parkman, Francis, 53
Perkins, Elmer, 109
Perkins, Frances, 109
personal consumption expenditures. See consumer demand and borrowing
philanthropy, 67
Phillips, A. W. H., 128
Phillips, Kevin, 73
Phillips Curve, 128, 133, 139, 142
political economic consequences, 5, 10, 17–18
populism, 38, 75, 80
poverty, as a function of character, 56, 58–61, 67. See also antipoverty programs
progressive tax system, 4–5, 23, 85, 159, 191–92, 198
Progressivism, 77–78, 80–81, 82, 86, 107
prosperity: Bush administration, 162; Eisenhower administration, 127; post–World War I decade, 89–90, 94–95, 97; post–World War II decades, 124; Reagan administration, 154–55
protective tariffs, 34–35, 39–40, 45, 72, 80, 84–85
Public Works Administration, 114
Pure Food and Drug Act (1906), 78
railroads, economic issues and, 45, 47, 49, 79, 85
Rauschenbusch, Walter, 70
Reagan, Ronald, 9, 23, 96, 144–57, 166
recessions: aggregate demand, 125–26; Bush administration, 2, 159; deficit spending programs, 129, 131–35; demand-side economics, 175–76; Eisenhower administration, 125–26; post–World War I decade, 87, 105; Roosevelt administration, 110–12
Reconstruction Finance Corporation, 106
reflation, 109
regressive tax system, 5, 84, 159
regulation legislation: banking industry, 114–15; Bush administration, 160–61; business investments, 95–99, 113, 147; Clinton administration, 158; corporations, 63, 72; employment, 120–22; higher education, 123; inflation rates, 138–39; Johnson administration, 135; Reagan administration, 153–54; reform efforts, 69, 72, 76–80, 84–86; Roosevelt (Theodore) administration, 76–80; Roosevelt administration, 113–17; taxation reform, 169–70; unionization, 72, 116; Wilson administration, 84–86
Reinhardt, Uwe, 197
Republican Party: divisiveness in, 80; economic policy, 43–44, 50, 51, 72–74; elitism charges, 83; neoconservative policies, 144–51; probusiness policies, 62, 73–74, 88–90, 94–98, 149–50, 156–61
residential construction, 93, 101–2. See also home ownership
Ricardo, David, 52
Riis, Jacob, 75
Robber Barons, 48, 53–54, 61–62, 66, 76, 94–95
Rockefeller, John D., 48, 75, 95
Rogers, Will, 89
Roosevelt, Eleanor, 108
Roosevelt, Franklin D., 16–17, 107–21
Roosevelt, Theodore, 16, 75–81, 82, 108
Rosen, Harvey S., 167, 169
Samuelson, Paul A., 128–29, 138
Say, Jean-Baptiste, 93–94, 145
Say’s Law, 93–94, 101
Schurz, Carl, 51
Schwartz, Anna, 141–42
sectionalism, 39–41, 43
Securities and Exchange Commission, 115
Securities Exchange Act (1934), 115
Selective Service Act (1917), 86
Servicemen’s Readjustment Act (1944), 120–21
Shame of the Cities, The (Steffens), 77
Sherman Antitrust Act (1890), 63, 69, 78
Sinclair, Upton, 77, 78
Singer Sewing Machine Company, 90
Skinner, Jonathan, 167–68, 171–72
slavery, 41–44, 50
Smith, Adam, 52
Social Darwinism, 15, 53, 56–67
social mobility, 31–32, 40, 45, 82–83
Social Security: Bush administration, 25, 161; future directions, 198–99;
Reagan administration, 150; regulation legislation, 115–16; Roosevelt administration, 113, 115–16
Social Security Act (1935), 115–16
Social Statics (Spencer), 59, 63
societal caste systems, 64–65
Solow, Robert W., 128–29
Sorensen, Theodore, 131
sound money, 103–4, 107
Spencer, Herbert, 53, 57–59, 63, 65
Sproat, John C., 55
stagflation, 7–8, 21, 139, 142–43, 150
Standard Oil Trust, 48, 75
Starr, Ellen Gates, 71
Steffens, Lincoln, 77
Stein, Herbert, 136–37
Stockman, David, 185
stock market transactions, 98, 100–102, 115
suffrage, 38, 60
Sumner, William Graham, 60–61
Supreme Court decisions, 63, 97, 117
survival of the fittest, 53, 55–56, 57–60, 64–65
Taft, William Howard, 79–81
Tarbell, Ida, 77
taxation: Clinton administration, 3, 18; deadweight effect, 157, 185; demand-side economics, 174–77, 179–85; economic policy, 22–23; estate taxes, 2, 71, 85, 160–61, 191; graduated income tax, 80, 84; Great Depression, 5; income tax, 23, 87; Johnson administration, 137–38; middle-class society, 8, 144, 161; Reagan’s philosophy, 151–52; reform efforts, 158, 169–70; Roosevelt
taxation (continued)
administration, 111–12; stagflation, 8; top marginal income tax rate, 18–20, 158–60, 164–74, 176–77, 179–88


Tax Reform Act (1986), 169–70

technological revolution, 89–90

Temin, Peter, 101

Tobin, James, 133, 175

Tocqueville, Alexis de, 12–13, 29–33
top marginal income tax rate, 18–20, 158–60, 164–74, 176–77, 179–88, 191
transportation infrastructure, 35–38, 40, 45, 49

Traveler from Altruria, A (Howells), 75

trickle-down economics, 73, 94–95, 156

trusts, 48, 63, 76, 78–79

Twain, Mark, 50

Tweed, William M. “Boss,” 49

unemployment. See employment/unemployment

unionization, 72, 76–77, 97, 116, 124

United States, concept of the, 33–34

United States v. E. C. Knight, 63

Uniting America, 196–97

university system, 45

urban intellectuals, 50–57

values, American, 196–99

veterans, 120–21

Vietnam War, 7, 136–37

Volcker, Paul, 143, 154–57

voodoo economics, 150

voting rights, 38, 44, 60

Wagner, Robert, 116

Wall Street, 98

Wanniski, Jude, 148

Warner, Charles Dudley, 50

Wealth and Commonwealth (Lloyd), 75

Westinghouse, George, 95

Whigism, 34–37, 43

White, Horace, 54

Wilson, Woodrow, 16, 80–86, 94, 107–8, 118

Wolfe, Alan, 197

women, economic issues and, 71, 118

working-class families, 55, 58–60, 92

working conditions, 52–56, 63–64, 85, 116–17, 124

Work Projects Administration, 114

World War I, 86–87

World War II, 118

Yankelovich, Daniel, 140, 196–97