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What Reaganomics Is All About

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In the late 1930s, Chester Carlson had a revolutionary idea—an electrostatic printing process—which he tried to sell to the top mimeograph companies in America. Turned away time and again, he finally converted his kitchen into a workshop and went into business for himself. There was risk and a shortage of capital, but the tiny enterprise survived and prospered.

Today, we know it as Xerox.

Were Mr. Carlson alive, he probably would ask, "What ever became of those smug mimeograph companies?" The answer is that they fell victim to what Joseph Schumpeter, the economic theorist, called "the creative destruction of capital"—the process by which a new idea enters the marketplace, making existing capital worthless.

What sounds like some arcane concept is the heart of Reaganomics. It explains the President's understanding of how growth is produced in the private sector, and why he believes, against a multitude of critics, that his across-the-board tax cuts for people will lead directly to new jobs.

To give the President credit, most policymakers have in recent years understood the process of job creation about as well as John McEnroe has mastered the art of diplomacy. Mention "jobs" and the picture is of giants of industry like Chrysler and U.S. Steel either protecting existing jobs or expanding plant and equipment to create new ones.

Actually, the Fortune 500 have experienced virtually no net job growth for more than a decade. The newest research shows instead that nearly all new jobs are coming from firms with precisely the opposite characteristics.

They are not only small, but minuscule. Nearly 70% of new jobs come from firms with 20 or fewer employees. Almost 100% of net new jobs in the Northeast come from such firms.

They are young. Most new jobs come from firms four years old or less.

They are unpredictable and unstable. The more stable a firm is, the less likely it is to produce new jobs.

Fail Nationally at Same Rate

Many of these fledgling enterprises will go out of business (four out of five do so within the first year), with new ones springing up to take their place. Frostbelt or Sunbelt, such businesses fail nationally in metropolitan areas at roughly the same rate—8% a year. Booming Houston, according to David Birch of MIT, proportionally has more business failures today than the old cities of Boston, Baltimore, Hartford—indeed more than almost every other city in the U.S.

What these facts and statistics create is a perfect object lesson. Houston's success stems not from a strong defense, but a strong offense. Entrepreneurs with new ideas are creating jobs at a pace far exceeding the rate jobs are lost, providing Houston a tremendous engine for prosperity.

The secret to maintaining high levels of national employment is hardly import quotas or Chrysler-like bailouts or even tax proposals aimed merely at modernizing existing plant and equipment.

The secret is creativity—encouraging a groundswell of men and women with fresh ideas to strike out on their own. The secret lies in the enterprises yet unborn, the oil wells yet undrilled, the inventions yet untried. Some of these fledgling entrepreneurs will fail, but others—like Chester Carlson—will replace today's capital and products with new and better ones, to the benefit of all of us.

The irony is that city planners, government growth economists and even successful corporate executives usually find this thinking unrealistic. The reason may be that productive change is not in their own vested interest. But it also may result from the great frustration that in this age of sophisticated econometric models and corporate "five-year plans," enterprise and job growth is just as unpredictable as it was decades ago. It still involves the dynamic process of two competing forces: success and failure. And perhaps most frustrating, it continues to depend directly on the creative implementation of new ideas by folks who, in the eyes of corporate America and the federal government, appear unpolished and relatively inexperienced.

If you have met a true entrepreneur even once, you know they tend to be nothing but crazy. Like Chester Carlson, they appear illogical dreamers, even though many have that inner genius for success. As a sophisticated business or government executive would you, or could you, take the risk of investing in such unpredictable characters knowing that many will end up as miserable failures? Perhaps this is why large institutions have not provided many permanent new jobs.

While entrepreneurs may be crazy, they are crazy like a fox. Most expect to lose money in the early years; still they make a careful calculation of current risk against future reward. They are society's dreamers and will endure incredible risk—far more than established business—with promise of great future reward.

In a sense, every individual is a potential entrepreneur. By that I mean we have near limitless sources of both human and financial capital—professionals in high tax brackets working only three days a week, mid-level industry technicians teeming with new ideas but apprehensive of the risks of individual enterprise, and many others.

Notice this is not just capital formation, but capital mobilization. Capital is more than money. It is also productive ability and thus exists in the minds, hands and hearts of people. The question is, how do you encourage these potential new wealth and job creators to invest their talent and savings in a new enterprise instead of in real estate, elaborate tax shelters, money market funds or in doing nothing at all? What they need is a climate of economic buoyancy, so necessary to individual initiative, and a system that capitalizes on human nature by strengthening the link between effort and reward.

House Speaker Tip O'Neill calls this "the whims of free enterprise." With all due respect, it is precisely such entrepreneurial risk-takers, now lining Route 128 outside Boston with small "hi-tech" firms, who are shouldering his city's job and tax base. If he simply visited these enterprises, the Speaker would discover that entrepreneurial success in America is taxed and harassed more than in just about any other free industrialized country. By the sheer force of logic, he would immediately help lower or eliminate the capital gains tax, lower the corporate rate, eliminate senseless overregulation and, most importantly, lower marginal tax rates on personal income across the board.

Potential Entrepreneurs

After all, 90% of American businesses still pay taxes through the personal schedules. These include proprietorships, partnerships and all the other noncorporate entities engaging in enterprise. Just as vital are potential entrepreneurs who, before entering a risk situation by pulling savings out of tax shelters, look instinctively to their personal tax bracket, which inflation has pushed higher and higher in recent years.

This is why President Reagan calls his across-the-board personal tax-rate reduction plan a "small-enterprise incentive" and why he favors the proposed end to the distinction between "earned" and "unearned" income (establishing a top tax rate on personal income of 50% now, with the goal of 35% as soon as is politically possible). Both increase the after-tax reward for greater entrepreneurial risk, for the direct creation of jobs.

Congress, with a false sense of sophistication, has always preferred more complicated solutions to the creation of jobs—the targeted gimmicks with built-in "triggers" that have failed for so many years. Yet the birth of an enterprise has an elusive, almost metaphysical quality that makes targeting, planning, certainty and "sophistication" most difficult. Something as common and essential as the ballpoint pen was conceived by, of all people, an insurance executive on his summer vacation. The arrival of the automatic transmission had little if anything to do with the multi-million-dollar engineering departments of Detroit's Big Three.

Growth involves ideas and thus is unpredictable. All we can provide is buoyancy—that sense of economic boundlessness where a person can, with energy and initiative, take a new idea as far and as high as he or she wants. If we can keep that initiative from being stifled, as it is today by an inefficient tax and regulatory system, people may once again follow their dreams. Allow entrepreneurs and potential entrepreneurs across-the-board worthwhile returns on their effort and they will start taking risks. Our entire economy will gain in production and jobs, and the nation will regain the energy and opportunity and spirit upon which its greatness depends.

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