Economic policies and actions in the Reagan administration

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Economic policies and actions in the Reagan administration

ALLAN H. MELTZER

Discussions of the Reagan administration's economic policy often make the assumption, implicitly perhaps, that the administration came into office with a plan or policy. If we mean by policy what economists usually mean, that there was a specified or planned path, contingent on events—a set of rules or medium-term strategies to guide fiscal and monetary actions—there is little evidence that the administration had an economic policy. This is not simply a failure of the Reagan administration. The same criticism would apply to the fiscal and monetary actions of other administrations for the past twenty years or more.

The Reagan administration, like some of its predecessors, had a set of goals or objectives that it hoped to achieve. The four goals featured in the administration's first program were (1) reduced government spending, (2) lower tax rates, (3) lower inflation, and (4) deregulation. The administration moved promptly to reduce tax rates, permitted the Federal Reserve to reduce money growth and raise interest rates to slow inflation, made some modest but largely unsuccessful efforts to reduce the level of nondefense spending, and did very little to implement a deregulation policy. If we include protectionist actions affecting imports with deregulation, the Reagan administration's record on deregulation is poor. If we separate protectionist programs, their achievements in deregulation are small; they consist mainly of a shift to less...
**Symposium: Reagan’s economic policies**

### Introduction

In the December 30, 1987, issue of the *New York Times*, Leonard Silk devoted an entire column to one of the sessions of the American Economic Association annual meeting. The session was entitled "An Economic Assessment of the Reagan Years through the Eyes of Different Paradigms."

Leonard Silk wrote that, "while Monetarists, Supply-Siders, Post Keynesians and Radicals judge the Reagan years from very different perspectives, they all fault the Administration for the shifting and unsustainable means by which it has sought to achieve its ends of increased military power, low inflation and strong growth, together with an enhanced international position for the nation. All the economists seem worried by the legacy of the Reagan years of internal and external debt, which will make it extremely difficult, or impossible, for the next administration, whether Republican or Democrat, to follow the model of Reaganomics."

The overflow audience attending this session provided obvious evidence of the widespread professional interest in these papers. The AEA decided not to publish the papers of this session in the Association’s *Papers and Proceedings*; consequently, as Organizer and Chairperson of this session, I asked the authors whether *JPKE* could publish this session. All but one agreed. Consequently, we present these papers and a discussant’s comment in the following pages of *JPKE*.

P. D.

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1 The paper entitled "The Empire Strikes Back" by Professors S. Bowles, D. M. Gordon, and T. E. Weisskopf will appear in the forthcoming issue of the *Journal of Economic Perspectives*.

2 Since the paper by Bowles and co-workers will be published and available to the readers elsewhere, we have included the discussant’s perceptive comments on that paper in these pages of *JPKE*.
burdensome administration and avoidance of efforts to regulate. In this area, the Reagan administration’s record compares unfavorably to the accomplishments of the Carter administration.

A fifth goal, to increase defense spending as a share of GNP, was not part of the economic program, but it had important consequences for the administration’s fiscal actions. In contrast to other areas, the administration developed policies to achieve its defense objectives, including a 600-ship Navy and a space-based program of nuclear defense. Critics may attack each of these programs or their implementation, but few can accuse the Reagan administration of failing to announce operational goals or of working to achieve them. Indeed, the opposite is true. Critics usually complain about the administration’s persistence in carrying them out.

This contrast between policies that are related to objectives in some areas and not in others is a feature of many administrations. The Reagan administration is often described by its critics as ideologically motivated; yet it is hard to find evidence that the administration was willing to trade much public support to reduce nondefense spending or entitlements or to end inflation. Indeed, monetary and budget decisions other than tax rates are better described as lacking direction, particularly after 1982, than as purposefully directed toward some goal.

A central question for social scientists is, why is this so? In my view, part of the answer is obvious. The administration was elected on a program which included, prominently, action to reduce taxes, increase defense spending, and lower inflation. It achieved these aims, at least in part, and, later, added tax reform as an objective. This objective, too, was achieved in the 1986 tax act. Where the administration faced strong public resistance to change, as in efforts to reduce transfer payments and welfare spending or to change environmental regulations, it both attempted and accomplished little. When public support for increased defense spending declined, the administration accepted reductions in defense spending relative to GNP. Less obvious is the choice of an electoral program. Below, I offer some hypotheses.

The administration’s major faults in economic policy are, I believe, failure to reform spending and monetary policy. I consider these policies more fully also.

Outcomes

Discussions of administration policy often confuse policy and action
and further confuse action and outcome. Administrations, like King Canute, can order the tide to stand still, but that does not make it happen. Politicians, and perhaps the public, give administrations more credit or blame for what happens during their terms of office than they deserve and, I believe, often neglect important long-run effects of policy changes. Perhaps that is why the evaluation of presidential administrations changes as we gain perspective after a generation.

Unfortunately, economists often play at the game of evaluating outcomes without concern for whether the outcomes are a consequence of action or of policy. Since we cannot agree on a model linking policy to outcomes, we, too, judge the inputs by the outputs. Here, then, is my brief description and some assessment of major events.

Inflation has been reduced to levels not reached since 1967. One-time price changes associated with devaluation and oil price movements now work in opposite directions instead of reinforcing inflationary monetary policy as at the end of the Carter administration. My estimate is that, properly measured, inflation has been cut in half. Once the 1981–82 recession ended, measures of welfare such as per capita real GNP or per capita real disposable income or per capita real consumption rose at rates of increase above those experienced in the 1970s. Employment increased; more that 65 percent of the potential labor force was employed for the first time, and the measured unemployment rate fell gradually into the range widely described as full employment. Stock prices rose. The Standard & Poor’s 500 is, after the fall, nearly double the 1980 average. In real terms, the S&P index is more than 30 percent above the 1980 level (and about 30% below the 1966 level). Manufacturing productivity achieved rates of growth not experienced on a sustained basis since the early 1970s. And, as administration spokesmen remind us frequently, we have a peacetime expansion of record length; the economy continues to expand, new jobs continue to be created, and manufacturing productivity continues to rise.

One way to separate the responses to administration policies from other events is to compare the experience of the United States to the experience of other countries for the same time period. During the first six years of the Reagan administration, U.S. output, industrial production, and employment rose relative to these variables in the Organization for Economic Cooperation and Development (OECD) as a group. Unemployment declined relative to the group. The average rate of inflation was lower in the United States than in the OECD countries for
the six years, but several OECD countries ended the period with lower
rates of inflation. Japan had higher growth of industrial production and
real GNP, and less inflation. Comparison with Japan is more favorable
to the Reagan administration if we look at the years of recovery, from a
base of 1982, through 1986 (on the reasonable ground that the costs of
disinflation should be charged against the inflating administrations).
During these years, the index of industrial production in the United
States rose from 103 to 125, a slightly higher percentage increase than
Japan's increase from 121 to 144. Average growth of U.S. real GNP
for the years 1983 through 1986—3.8 percent—is only 0.1 percent
below the rate of growth of Japan's GNP in this period.

The Reagan administration inherited an economy with high infla-
tion, slow growth, and an uncertain program. It will leave to its
successor large budget and trade deficits but lower inflation and higher
real per capita incomes. It will also leave some serious problems,
largely unattended or mismanaged. These include the international
debt of developing countries; the accumulated liabilities of thrift institu-
tions, government credit agencies, and the Federal Savings and Loan
Insurance Corporation (FSLIC); the trade balance; and the budget
deficit.

**Monetary policy**

The President's Economic Recovery Program called for a gradual
reduction in money growth to reduce and eventually eliminate infla-
tion. The dollar was to float freely with central bank intervention
limited to periods of turbulence. Inflation was not eliminated, and the
gradual reduction in money growth was not instituted. In retrospect,
we see sharp deceleration of money to 1982 followed by sharp acceler-
ation. The deceleration of 1981–82 was characterized by substantial
uncertainty about its magnitude and persistence, and uncertainty con-
tinues to be a dominant characteristic of monetary actions.

Once inflation was brought to the 3 to 5 percent range, many in the
administration and Congress concluded that the inflation problem was
less important than recession, international debt, and the 1982 congres-
sional elections. Money growth rose and interest rates fell. The rapid
reduction of inflation and the uncertainty premiums in real interest
rates, however, left a residue of problems for many thrift institutions,
federal credit agencies, the FSLIC, some banks, some farmers, and
others. The administration has yet to develop a strategy to resolve these
problems, and the passage of time has not brought the problems closer to solution. Delay has been costly. One estimate suggests that the FSLIC could have closed all failing thrift institutions in 1982 at a cost of $6.5 billion. By late 1987, the cost is estimated to be about $50 billion (Weicher, 1987). Perhaps because this cost does not appear in the budget, it is generally ignored in discussions of budget policy, but it represents a cost that future taxpayers are likely to meet.

Uncertainty and lack of a coherent monetary policy were not limited to 1981–82. During the years 1984–87, the Reagan administration shifted from a freely fluctuating exchange rate to encouraging dollar devaluation first by talk and then, in 1986, by increasing money growth. These actions were followed by a decision at the Louvre in January 1987 to set a band for the exchange rate against principal currencies. Within a few months, the dollar was overvalued relative to the agreed-upon rates, so maintenance of the band required increased money growth in Germany and Japan and lower money growth in the United States. The band required higher interest rates. Between July and October 1987 interest rates on long-term U.S. government bonds increased approximately 25 percent (from 8½% to about 10½%). When anticipations of further increases in interest rates contributed to a rather dramatic decline of prices on the world's stock exchanges, the administration shifted its position again. The dollar declined about 8 to 10 percent below the presumed bottom of the previous band.

It is difficult to find a consistent pattern, much less a coherent policy, in these shifts within less than one year from efforts to force devaluation by raising money growth and lowering market interest rates to a program of stabilizing exchange rates, lowering money growth, and raising interest rates and then to a program of lowering interest rates and allowing the dollar to fall. The shifts suggest an extremely short-term focus unrelated to the long-term problem of adjusting the trade and payments position of the United States without forcing a recession and without increasing inflation.

The long-term trade and payments problem for the United States is to shift resource allocation so as to raise output relative to spending, particularly consumption spending. The United States will be a net debtor, with net interest and dividend payments to foreigners. Current account balance will require a modest trade surplus. Assuming for illustration that the net capital position reaches about $800 billion net liability before current account balance is achieved, the United States will have nominal interest and dividend payments of approximately $70
to $80 billion and real interest payments of no more than $40 billion a
year. This is not a heavy burden in an economy that will be producing at
a rate of more than $5 trillion by the end of the decade. The bigger
problem is to achieve balance without inflating (to reduce the value of
the debt) or forcing a recession to reduce spending on imports. The
United States can achieve international balance, on my assumptions,
with a one-time adjustment of $150 billion to close the trade account
and, say, a permanent adjustment of $70 billion to service its liabilities.
This adjustment is a much larger share of current or prospective world
trade (approximately 10%) than of domestic GNP (4%). Adjustment
will require some rather substantial changes as other countries shift
from net exporters to net importers.

What can monetary policy contribute to the trade adjustment and the
economy? Monetary policy can remove one source of instability from
the domestic economy, can achieve a relatively stable average or ex-
pected price level, and, in concert with other countries, can reduce (or
remove) one source of exchange rate variability. Monetary policy can-
not prevent a real devaluation of the dollar that markets demand. For
countries like the United States, a policy that allows nominal exchange
rates to fall (or rise) is a less costly method of adjusting real exchange
rates and relative costs of production than a fixed nominal exchange
rate. The latter requires that any reduction in relative costs of produc-
tion be achieved by reducing real wages (and other costs of production)
relative to foreigners’ wages (costs).

The administration’s recent efforts to fix the exchange rate are
mistaken, in my judgment, because they sacrifice the opportunity to
achieve a more stable price level and impose a policy that is likely to
bring on a recession here and inflation abroad. The Bretton Woods
agreement, the Smithsonian agreement, the Carter administration’s
locomotive, and the Louvre accord all ended with high money growth
and rising rates of inflation abroad. If foreigners refuse to inflate, as
recent experience suggests, the United States must reduce money
growth to adjust the real exchange rate while maintaining the nominal
exchange rate. This is likely to produce a recession. A recession is a
costly way to reduce spending relative to output and lower the trade
deficit. A fluctuating exchange rate may not avoid a recession, but I see
no reason to adopt a policy that increases the chances of a recession by
imposing wage reduction in place of devaluation.

In summary, the Reagan administration’s monetary actions have
been erratic and have contributed to uncertainty. No one can have much
confidence in announcements of money growth or commitments to either fix or float the exchange rate. At 4 percent to 5 percent, inflation is higher than in past peacetime years but lower than when the administration came into office. Although some members of the administration complained about excessive and erratic Federal Reserve policies in 1981–82 and before, the President and the administration have made no major changes in the conduct of monetary policy. Nothing has been done to reduce discretion, to develop institutional arrangements that would reduce uncertainty about future inflation, or to institutionalize a policy of maintaining expected price stability.

The hard question is, why did the administration adopt these tactics? I do not know. My best guess is that, once inflation fell, popular support for the austerity believed necessary to get additional reductions in inflation declined. The Reagan administration, like its predecessors, shifted from stop to go.

**Fiscal policy**

In contrast to its inconsistent monetary actions, the Reagan administration implemented a clear tax policy. In 1981, Congress passed, and the President signed, the Economic Recovery Tax Act. The act reduced personal income tax rates in three installments, introduced indexation of tax rates, and lowered corporate tax rates, the latter mainly by changing depreciation allowances. Adjustments in 1982 and 1986 increased corporate taxation so that, on Blanchard’s (1987, p. 23) estimates, the user cost of capital at current rates of inflation and real rates of return is now lower for structures and higher for equipment than before the Reagan administration took office.¹

The 1986 tax act shifted taxes from households to business, eliminated a long list of exemptions and special provisions, reduced distortions, and encouraged consumption relative to investment. The most prominent features of the 1986 act were the reduction in scheduled personal, marginal tax rates to a maximum 33 percent rate, the introduction of a much flatter tax schedule (particularly so after combining Social Security taxes) with income tax rates of 15 percent and 28 percent, and the elimination of an estimated 6 million taxpayers from the income tax rolls.²

¹The same is true of Blanchard’s computation of the effective tax rates on structures and equipment.

²The 33 percent marginal tax rate is above the 28 percent scheduled rate because some deductions are phased out as income rises.
Table 1

Federal revenues, outlays, and deficits as a percentage of GNP

<table>
<thead>
<tr>
<th>Fiscal years</th>
<th>Revenues</th>
<th>Outlays</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-55</td>
<td>18.1</td>
<td>18.4</td>
</tr>
<tr>
<td>1956-60</td>
<td>17.7</td>
<td>18.0</td>
</tr>
<tr>
<td>1961-65</td>
<td>17.9</td>
<td>18.7</td>
</tr>
<tr>
<td>1966-70</td>
<td>18.8</td>
<td>19.7</td>
</tr>
<tr>
<td>1971-75</td>
<td>18.1</td>
<td>20.0</td>
</tr>
<tr>
<td>1976-80</td>
<td>18.5</td>
<td>21.4</td>
</tr>
<tr>
<td>1981-85</td>
<td>18.9</td>
<td>23.6</td>
</tr>
<tr>
<td>1986-87</td>
<td>18.6</td>
<td>22.6</td>
</tr>
</tbody>
</table>


Two indications of the magnitude of the reduction in marginal rates are comparison with the top marginal tax rate when the Reagan administration took office and comparison with earlier periods. The top marginal tax rates in 1980 were 50 percent on earned (or labor) income and 70 percent on income from capital (unearned income). One has to go back to the late 1930s to find a rate of 28 percent on the comparable level of real income. And one must go back to the 1920s to find a lower maximum scheduled tax rate.¹

The administration failed to reduce either real government spending or transfer payments absolutely or as a share of GNP. A comparison with previous administrations puts the administration's outlays and revenues into context. Table 1 shows these data as a share of GNP. Revenues and outlays include on- and off-budget items.

Table 1 brings out two facts relevant to discussions of the budget deficit. First, the average share of GNP taken in taxes has varied very little during the postwar period. The principal changes have come on the expenditure or outlay side. Revenues have grown at the same rate as nominal GNP. Second, the share of GNP spent by government started to increase in the late 1960s or early 1970s and is now approximately 4 percentage points above the levels of the years 1951–65. Outlays have grown relative to nominal GNP.

These data suggest that the Reagan administration's tax changes had

¹Historical data on tax rates are from the Tax Foundation (1975). Effective tax rates changed much less than scheduled rates under the 1981 and 1986 revisions.
little effect on average revenue. It seems misleading to describe the tax cuts as the cause of the budget deficit. A more accurate statement is that the tax changes in 1981 and 1986 kept the share of revenues at their postwar average while the outlays share continued to rise.

When we look in more detail, we find that during the last 20 years personal taxes (as a percent of GNP) have remained in the 8 to 10 percent range. The big changes on the revenue side are a reduction in the share of corporate taxes and an increase in the share of Social Security taxes. Most of these changes occurred before 1981. On the outlays side, defense spending (as a percentage of GNP) increased during the Reagan administration by approximately 1.5 percentage points, but the share of GNP spent on defense is well below the experience of the Eisenhower or Kennedy administrations. There is no evidence that transfer payments or nondefense spending have decreased relative to GNP. Some programs have been reduced; others, including health and medicine and agricultural support, have increased relative to GNP. Net interest payments have increased from 9 percent of outlays in 1980 to 13.5 percent in 1986.

Most of the interest outlays should be matched by revenues (from inflation), but these revenues are not counted as part of the government's receipts. The Congressional Budget Office (CBO) reports the "primary deficit," which excludes the inflation component of interest outlays. With this adjustment, the budget deficit as a share of GNP is in the neighborhood of 1.5 percent, down from the recent peak of 2.9 percent in fiscal year 1983 but approximately 1.5 percent above the 1980 level. A further adjustment that has some merit would consolidate the state and local government surplus of more than $60 billion.

My discussion should not be read as an attempt to dismiss the budget problem. I confess that I am puzzled by the propensity of many economic journalists, some economists, and much public discussion to regard the budget deficit as a matter requiring prompt increases in taxes, whatever their effects on the economy. Much of the popular discussion of the budget deficit suggests that the U.S. fiscal position keeps the economy either on the brink of a calamity or headed toward one. In contrast, much recent academic discussion is in the context of so-called Ricardian equivalence, which views the deficit as equal to the present value of future lump sum taxes. On this view, the budget deficit has no macroeconomic effects. Government spending and distortions caused by the use of non-lump sum taxes, subsidies, and inefficiencies modify the conclusions about the budget.
I do not share either view, but I recognize that what we know is much
less certain than either of these claims. A considerable amount of
empirical research has not isolated reliable or consistent effects of
deficits, debt, expected deficits, or debt on real interest rates. Theoretical
work on deficits, debt, and capital accumulation finds such effects
in models when income redistribution is admitted or in models with
finite horizons. Some models find effects of the deficit on investment,
although writers may recognize that the estimates are tenuous
(Blanchard, 1987, p. 40).

Public hand-wringing about the deficit is surprising, to put it mildly.
The deficit is an endogenous variable. The effect of the deficit on
investment, holding the composition of government spending constant,
strikes me as secondary to the direct allocative effects of government
spending. Does government spending (or taxes) distort resource allo-
cation toward consumption or toward investment? In the United States,
government has not increased investment spending (on infrastructure).
But, government has increased spending for defense—a public good.
There is some evidence that a majority of the voters favored the in-
crease. What is wrong with shifting part of the burden of a one-time
increase in defense spending to the future, if that is what happens?

A fear, commonly expressed, is that a persistent deficit will eventual-
ly produce inflation. General equilibrium models with an intertemporal
budget constraint produce this implication, particularly if the real rate
of interest exceeds the real growth rate. It is hard to find supporting
evidence, particularly for developed economies. Experience in Japan
and Italy, with deficits as a share of GNP similar to, or larger than, the
deficit share in the United States, provides little support within the
ranges observed to date. The United States in the 1950s and 1960s and,
currently, Japan, Italy, and Britain show ratios of public debt to GNP in
the range toward which the United States is now headed (40 to 45% or
higher). Some of these countries experienced inflation, but inflation
did not accelerate. In Japan, inflation declined persistently, although
the budget deficit remained above 3 percent of GNP as late as 1986, and
the debt-to-GNP ratio is above 40 percent.

Politics and policy

A positive issue which social scientists must address is why administra-
tions choose the strategies and tactics that they adopt. Why did the
administration adopt its budget policy or fail to adopt a coherent mone-
tary policy? Chance may be part of the answer. Can we say more?

A main lesson from public choice or political economy is that policies are chosen to maximize the utility of those choosing the policies. Winning elections is one source of utility. Social benefit may be another, but it is not, as in standard welfare economics, the only argument in the policymaker's utility function.

The Reagan administration appears to have been more successful in getting many of its programs through Congress than several previous administrations. The President was re-elected overwhelmingly and remained popular and well regarded at least through the first six years of his term and perhaps longer. Public support of the President gave the administration capital that it could use to achieve some of its aims. Economists will be no more useful than journalists if they restrict their analyses to criticisms of failures to achieve objectives that the voters do not want. The problem is to explain the choices as the result of constrained, maximizing behavior.

Why did the Reagan administration choose to run deficits that are large relative to previous peacetime experience in the United States? One possibility is that the deficits were not anticipated. This is improbable but, if the deficits were a surprise, the administration could have offered a policy to reduce the deficit that was acceptable to a majority in Congress. Aside from supporting Gramm–Rudman–Hollings, the administration did not stress policies to reduce the deficit. Candidates like Walter Mondale, who made deficit reduction a major issue, were defeated.

Two complementary explanations of this observed willingness to tolerate a large deficit have been suggested by recent work in political economy. First, as suggested by Alesina and Tabellini (1986), a large deficit restricts the growth rate of spending in future administrations. Leaving a large deficit may be an efficient way of restricting future government spending, if the current administration has that goal. Second, Cukierman and Meltzer (1986) show that deficits are a means of redistributing wealth or income from future generations to the current generation. In a growing economy, future generations are wealthier. The present generation can share in the increased future wealth by leaving more debt and less capital to its progeny. Cukierman and Meltzer, using a general equilibrium model, show the groups that benefit from increased deficits include nonworkers, who gain from the increased consumption, and rentiers, who gain from the rise in interest rates. People whose income is mainly from wages lose if capital and labor are complements in the production of output.
These explanations may not be complete, but they suggest that the fiscal program followed by the Reagan administration appealed to several groups of voters. If these groups, plus those who gained from tax rate reduction, increased growth of the real economy, or other events of the period, include enough voters, we have sufficient reason for maintaining an unorthodox fiscal program.

Politics is mainly about income redistribution—who pays and who receives. We cannot, as economists, expect to explain much about what happens to policy without learning more about politics and analyzing the interactions between politics and economics.

The Reagan administration is, like all administrations, a political event. Its aims included getting re-elected and making the Republican party a majority party; its strategies and tactics were related to those ends. It was not elected to establish economic optima, even if we knew concretely how to do so.

In practice, politics in a modern democracy is, like marketing, a mixture of finding out what the public wants and expanding the opportunity set to make the public aware of possible changes that they may want. Policymakers, including presidents, often face tightly constrained choices. Choosing programs with little public support is normally not a survival strategy. In a period of perceived crisis, policymakers have a wider range of choices, but their choices must be seen ex post as contributing to a solution.

The Reagan administration made some choices. Choices about defense and foreign affairs, though they affect the economy, lie outside our discussion. In economic policy, the Reagan administration concentrated its efforts on personal tax reduction and tax reform. The latter was not a popular issue; the administration, with help from a few members of Congress, chose to use its resources—including political capital—for this purpose.

The administration produced the major shift in tax policy that it promised and, though tax rates may increase in the future, we are unlikely soon to see a return to the pre-Reagan tax rates. I doubt that many would have predicted a decade ago that any government in the United States would get elected on a program of tax reduction or, if elected, radically change the tax system and encourage similar movements in other countries.

Some may cheer; others hiss. That has more to do with politics and values than with positive analysis. A majority of the voters seems to have been persuaded that the outcome was better than the alternative offered. The next administration may be pressed to do as well.
REFERENCES


