

1986

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## Citation of this paper:

Tobin, James. "Reaganomics after Five Years." Centre for the Study of International Economic Relations. Global Perspectives Lecture Series, 1986-03-G. London, ON: Department of Economics, University of Western Ontario (1986).

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6123

ISSN 0831-7089  
ISBN 0-7714-0733-5

THE CENTRE FOR THE STUDY OF INTERNATIONAL ECONOMIC RELATIONS

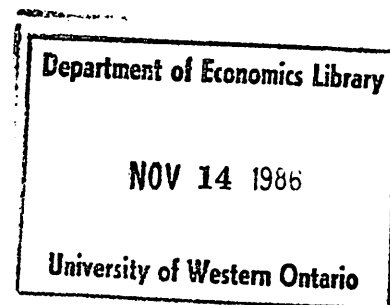
GLOBAL PERSPECTIVES LECTURE SERIES

1986-03-G

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March 11, 1986



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March 11, 1986

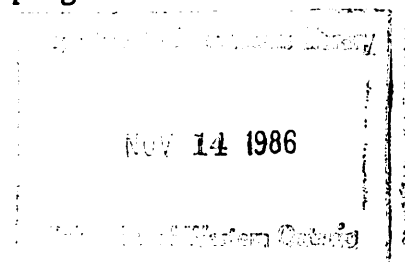
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## REAGANOMICS AFTER FIVE YEARS

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Rarely in a democracy does a new government take office determined to change course radically, and endowed with the electoral mandate to enable it to do so. Franklin Roosevelt fifty-four years ago and Lyndon Johnson twenty-two years ago were the only United States Presidents in my lifetime who had and used this opportunity, until Ronald Reagan was inaugurated in 1981. Most Administrations veer only moderately from the established compromise consensus they inherit. Their minor course adjustments reflect the difference from their predecessors and opponents in the balance of interests in the coalition that elected them. Leaders like FDR, LBJ, and Reagan -- and across the sea, Margaret Thatcher -- manage to shift bodily the whole path of policy. After them, the centrist consensus from which successors will to deviate is forever different.

Ronald Reagan came to Washington with a strong and distinctive social and economic ideology. Roosevelt and Johnson, pragmatists both, were definitely not ideologues. They responded decisively and imaginatively to the situations they confronted; the New Deal and the Great Society were not pre-ordained by any long-held doctrinal beliefs of their builders. Liberalism, in its twentieth century meaning, is a loose set of attitudes and values rather than a coherent ideology. But there is a ready-made right-wing ideology, and Reagan came to Washington in 1981 with programmatic agenda conceived in its image.



## THE ECONOMIC IDEOLOGY OF THE REAGAN ADMINISTRATION

What was the economic ideology President Reagan brought to Washington?

Basically, of course, it was the ancient theme of nineteenth century "liberalism," celebrating the miracle of Adam Smith's Invisible Hand, the virtues of free markets, free enterprise, and laissez faire. It has long been espoused by the Right in the United States. After the second World War conservative intellectuals, business leaders, and politicians rallied to this flag even when it was outside the general consensus. Barry Goldwater was their hero in 1964, but Johnson clobbered him. Ronald Reagan became a public figure and a potential political leader by his talent for communicating the ideology on radio, television, and in person under the sponsorship of General Electric.

The Invisible Hand. Free market ideology is an extravagant version of the central paradigm of economic theory. The modern theory of general competitive equilibrium and its theorem that such an equilibrium is in some sense a situation of optimal social welfare make rigorous the intuitive conjectures of Adam Smith and subsequent classical and neoclassical economists. Economists know the restrictive conditions of these proofs: they can list the standard caveats and qualifications. These are lost in the arena of politics and public opinion, and they are increasingly glossed over by economists themselves. At the same time and for the same reasons that conservative ideology was gaining in public favor, its counterpart in

economic theory was being taken more and more uncritically throughout the economics profession.

Every ideological movement has its own version of history. As Reagan tells it, the U.S. economy was a shambles when he came to its rescue in 1981. All the blame he layed to federal economic policies under previous Administrations since World War II: chronic deficits, over-taxation, large and growing government, loose monetary policy, macro-economic "fine tuning," intrusive regulation, bureaucratic waste, misguided welfare handouts, and so on. In this story there is no credit for the remarkable performance of the economy in the 1950s and 1960s and no acknowledgment of the roles of OPEC, the Iranian revolution, and other external shocks in the 1970s.

Government as Leviathan. In renascent conservative doctrine, government "is the problem, not the solution." In the 1970s this message found receptive ears in a populace disillusioned by Vietnam, Watergate, and the economic disappointments of the decade. Government regulations and taxes, according to candidate and President Reagan, shackle the energies and initiatives of the citizens. Government, especially central government, has become a Leviathan, devouring the resources of the nation. Government has expanded far beyond its proper functions of national defense, internal order, protection of property rights, and enforcement of contracts. Government has no business redistributing income and wealth, beyond minimal "safety nets" for the truly poor and disadvantaged. Even these needs should be met primarily by private charity, supplemented by local governments.

The objective of highest priority for the Reagan Administration has been from the beginning to reduce the size of the federal government and budget relative to the economy. This implied severe cuts in federal civilian

spending, because Reagan was also committed to a sharp increase in military expenditures. The non-defense budget, it is true, had been growing faster than GNP. This was almost entirely in social security benefits, for old age and disability and for Medicare, health insurance for the aged, introduced by Lyndon Johnson in 1966. These are universal entitlements, not needs-tested, and the growth of spending for them had been closely matched by earmarked payroll taxes. Social security growth reflected a combination of demographic trends, economic developments, fiscal miscalculations, and political generosities, notably on the part of the Nixon-Ford Administrations and their Democratically controlled Congresses. The experts in the Reagan team knew these facts, but the President preferred to ignore them and talk about the excessive size of the budget as a whole.

The Strategy of Cutting Taxes First. The idea that the federal budget must stop growing faster than GNP was not new; both President Ford and President Carter had committed themselves to this objective. Reagan, however, was ready to slaughter cows that previous Administrations and Congresses regarded as politically sacred. He was also ready to follow a strategy that his predecessors eschewed as unsound. That was to cut taxes first, accept the resulting deficits, and use the abhorrence of deficit spending, among politicians, financiers, and the general public, as a bludgeon to force Congress to cut civilian spending. Cutting the budget, civilian spending and taxes both, was and is the prime goal.

Only a conservative Republican President could have adopted this strategy without provoking an outraged response from the financial community, and negative reactions in financial markets. Such responses forced Jimmy Carter to modify several of his proposed budgets. For example,

when his budget for fiscal year 1979 was proposed in January 1978, it showed a deficit of \$60 billion. The outcry forced Carter to submit a revised budget with a much lower expected deficit, abandoning some expenditure initiatives and scaling down some tax cuts. While Reagan and his spokesmen have always given lip service to the old conservative orthodoxy of budget balance, it has always been a distinctly subordinate objective. The President has often explained the strategy of lowering taxes first by saying that the way for parents to keep kids from overspending is to cut their allowances. We are now engaged in the final rounds of the strategy. From the President's point of view the Gramm-Rudman act could be the decisive victory; but many members of Congress of both parties regard it as a way to force the President to agree to cut defense spending and raise taxes.

Supply-side economics and the budget. Supply-side economics gave Reagan another argument for reducing taxes faster than he could hope to lower expenditures. This argument is not wholly consistent with the strategy just discussed, but ideology and political economics do not have to be consistent. The argument was that cutting tax rates would actually raise tax revenues, a claim that made famous the economist who made it famous. Arthur Laffer drew his curve on a cocktail napkin for the instruction of Congressman Jack Kemp. The curve dramatized the incontrovertible truth that beyond some point a rise in tax rates will discourage taxable activities so much that revenues actually decline. Laffer and Kemp jumped to the unsupported conclusion that U.S. rates were already there. This assertion was naturally an instant sensation in conservative political and business circles, lending as it did apparent scientific authority to something they wanted very much to believe. Ronald Reagan believed it, and he still does.

Raising taxes, he continues to say, will be devastating to the economy.

Economic growth propelled by tax cuts, he continues to say, will balance the budget. Members of his Administration who thought otherwise and had the courage to speak up --like Martin Feldstein, who never bought the Laffer line, and David Stockman, who once did but learned better -- are now in private life.

Supply-side fiscal economics as espoused by Laffer, Kemp, and Reagan is reminiscent of extravagant claims advanced by some Keynesian enthusiasts that tax cuts would pay for themselves in revenues generated by expansion of economic activity. The expansion they had in mind was "demand-side." The scenario was that in an economy with excess unemployment and redundant industrial capacity, the spending of tax cuts would prime the pump. Sober Keynesians believed that tax cuts --or additional government expenditure-- would stimulate activity in a slack economy, but not by enough to avoid an increase in the deficit.

The label "supply side," which had a great deal to do with the attention the doctrine rapidly received, was coined satirically by Herbert Stein in order to distinguish its fiscal policy from Keynesian demand-side fiscalism. There are in logic several differences. From a demand-side viewpoint, additional government spending is at least as expansionary as private spending, mostly on consumption, induced by tax reductions. The supply-siders, however, contend that both cutting tax rates and reducing public spending are stimulative. The supply-side recipe is supposed to work by giving private individuals greater after-tax incentives to work, save and invest, innovate, and take risks --not to consume. These responses are supposed to augment productivity and raise the economy's capacity to produce



from a given employed labor force, while demand-side fiscal stimuli are intended to raise the economy's production from given capacity by employing more of the available labor force. Laffer's theory, if valid, should work even if unemployment were at and remained at its full employment minimum, while a Keynesian fiscal prescription is intended only as therapy for recession or tonic for an uncompleted recovery.

These differences did not prevent the supply-side protagonists from claiming the 1964 Kennedy-Johnson tax cut as a precedent, even though its motivation and success were demand-side and even though there is no credible evidence that by itself it led to net reduction of the deficit. Nor has it prevented them from staking claim to the 1983-85 U.S. recovery, even though that fits a standard Keynesian scenario.

There is of course a less flamboyant, less novel, and more professional supply-side economics, namely good straight microeconomics. Economists of all shades of opinion recognize that taxes and transfers have incentive and disincentive effects. This has been recognized in policy too, for example the Investment Tax Credit introduced in the Kennedy Administration and the sliding scales relating welfare benefits and food stamps to recipients' own resources, introduced under Johnson and Nixon. Martin Feldstein joined the Reagan administration after leading for a decade important research on the effects of taxation of capital income on investment and saving. The Reagan ideologues had the directions of effects right; the trouble was, as Charles Schultze observed, that they multiplied reasonable empirical magnitudes tenfold.

Monetarism. Monetarism was another ingredient in the triumphant conservative ideology of 1981. Strict control of money supply growth was

accepted as necessary and sufficient for disinflation; the Federal Reserve should stick to non-inflationary targets and hit them. Supply-siders were somewhat uncomfortable, fearful that the Fed would not accommodate the expansion their own policies would generate. The Administration tried feebly to argue that monetary stringency would take care of prices while supply-side stimuli raised output. Inflation is, after all, "too much money chasing too few goods," and their policies would shrink the money and multiply the goods.

Later the supply-siders became downright hostile to the Fed. They blamed Paul Volcker, the Chairman of the Federal Reserve Reagan inherited from Jimmy Carter but reappointed, for the incomplete success of their program. They joined their voices to those of some Keynesians in urging more accommodative monetary policy and lower interest rates. Unlike the Keynesians, they also attacked the present international monetary regime, floating exchange rates, and called for return to the gold standard or the Bretton Woods fixed-parity system or some variant. This always had been a plank in the platform of the original supply-side guru Robert Mundell and his popularizer Jude Wanniski, who were very important influences on Kemp, Stockman, and Laffer. The President has flirted publicly with this idea, but the pragmatists of his Administration have so far kept it from becoming serious policy. The ambivalence of the Reaganomics intellectuals towards monetarism and floating exchange rates sets some distance between them and the world's leading conservative economist, Milton Friedman.

Supply-side thinking differentiates Reaganomics also from the more orthodox conservatism guiding the policies of other governments these days, notably in Japan, West Germany, which sets the tone for Europe, and the

United Kingdom. Those governments share Reagan's faith in laissez faire, but they also subscribe to traditional budgetary prudence and firm monetarism. Reaganomics enthusiasts cite the greater recovery of the United States since 1982 as proof of the superiority of their brand of conservatism over the conventional variety.

#### MACROECONOMIC MANAGEMENT 1981-85

In 1981 Congress adopted the President's economic and budgetary programs, to an amazing degree. The Democrats retained nominal control of the House and a near majority of the Senate. But, bulldozed by their disastrous defeat in the Presidential election, they submitted with docility and me-too-ism. Tax cuts amounting to about 3% of GNP were passed, to be phased in over three years. Simultaneously, a buildup of defense spending, designed to raise it eventually from 5.5% to 8% of GNP, was begun. (As the Administration points out, defense would still be 2-3 percent points lower relative to GNP than in the 1950s and 1960s.) Civilian budget cuts were passed almost equal in eventual magnitude to the defense increases. Entitlements were still growing, however. The Administration made some noises about taking them on, but drew back when the flak made clear that social security was one ancient monument the opposition could and would defend.

The official 1981 forecasts of the economy and the budget were very rosy. In part, they were phony, as Stockman admitted in his unguarded interview with an Atlantic writer, for which the President took him to the proverbial woodshed. In part, they reflected an unjustified optimism about the economy, shared by most private forecasters at the time.

In October 1979 Paul Volcker had instituted a strict monetarist regimen designed to rid the economy of the high inflation accompanying the second oil shock. A recession began in spring 1980 --contributing to the defeat of Jimmy Carter-- but there was a slight recovery at the end of the year. Anyone who understood Volcker's policy should have known that this was a temporary blip; I did understand the Fed's intentions. Recession resumed with a vengeance only months after the inauguration, too late to be taken into account in the budget and economic prospectuses of the new Administration.

Later in 1981, people began to recognize realities: Deficits of a new order of magnitude were in prospect. Moreover, they were not just cyclical; they were structural, that is, they would continue even when the economy was operating, and generating government revenues, at normal rates of unemployment and capacity utilization. One big reason was the growth of interest payments on federal debt. High interest rates were in part the consequence of the unprecedented fiscal stimulus, superimposed on the Fed's monetary policy. High interest payments, in turn, enlarge the deficit --altogether, a vicious spiral.

Alarm in the financial community and in Congress about prospective deficits led to some serious efforts to contain them. In 1982 Congress passed, and the President reluctantly signed, the Tax Equity and Fiscal Responsibility Act (TEFRA), enhancing revenues and in particular taking back some of the more egregious goodies given corporations by the Economic Recovery Tax Act of 1981 (ERTA). Furthermore, in one of the finer examples of statesmanlike cooperation between Congress and the Executive, between parties, and among interest groups, a blue-ribbon commission chaired by Alan

Greenspan arrived at compromise recommendations to assure the "solvency" of Social Security. The package was enacted in 1983, containing both benefit reductions, payroll tax increases, and other provisions projected to put the account in the black for several decades ahead. Indeed the Social Security Trust Fund will contribute surpluses of 2-2.5 percent of GNP to the unified federal budget in the 1990s. In almost every year after 1981, Congress has nibbled at the deficit, making expenditure cuts and also "enhancing revenues," to use the obligatory euphemism for tax increases. These efforts have added up, until now even in the absence of Gramm-Rudman the structural deficit will be declining.

The severe recession ended late in 1982, several months after the Federal Reserve reversed policy. There were several reasons for the reversal: The downturn, which took unemployment close to 11 percent, more than three points higher than on inauguration day in January 1981, was deeper and faster than the Fed had expected. An unexpected slowdown in the velocity of money had made the Fed's monetary growth targets more restrictive than the Fed had intended. Third world debtor countries and the banks in the United States and other advanced countries who had lent to them were on the brink of a financial crisis. Congress, by passing TEFRA, was showing some appreciation of the federal budgetary problem and withdrawing some of the fiscal stimulus that the Fed regarded as excessive.

In 1983 and 1984, after Volcker had turned the economy around, the 1981 tax and expenditure programs were coming into force and delivering a massive fiscal stimulus to aggregate demand. This was well-timed Keynesian recovery policy of unprecedented magnitude. Of course, it was quite serendipitous. The Administration had not expected a recession in the first place, and had

on principle repudiated counter-cyclical demand management. Taxpayers appeared not to realize that the cuts they were enjoying were supply-side measures designed to be saved rather than spent. Defense procurement and contracts percolated through the economy too. The fiscal stimulus to demand led to such rapid recovery at some times that the Fed felt it necessary to apply the monetary brakes. As a result, real interest rates, i.e. market rates corrected for inflation, remained high, certainly much higher than if the same recovery had been driven by monetary policy combined with pre-1981 budget policies.

The United States drifted into a bizarre and extreme mix of tight monetary and easy fiscal policies, with several unpleasant consequences: The federal debt would be growing faster than GNP as far as the eye can see, because interest on the debt alone was increasing the debt faster than the sustainable growth rate of the economy, while expenditures other than debt interest would exceed revenues even when the recovery was complete. High interest rates induced a net capital inflow and appreciated the dollar enough to yield an equivalent current account deficit. As a result, the recovery was unbalanced; manufacturing industries and agriculture suffered formidable international competitive disadvantage, while services and other non-traded sectors flourished. Pressures for protection of jobs and markets in the disadvantaged sectors threatened the political consensus that had long supported a liberal U.S. commercial policy.

Let no one underestimate the drastic nature of the change in fiscal policy in 1981. While the federal government seldom ran surpluses in the last forty years, before 1981 its deficits were modest, virtually always less than 2 percent of GNP, compared to the 4 and 5 percent deficits of the

Reagan years. Before 1981, cyclical recoveries brought deficits down close to zero, and the structural budget was often in surplus. Now we have structural deficits 3 to 4 percent of GNP. Before 1981, the debt/GNP ratio had declined, from more than 100 per cent at the end of the second World War to 25 percent in the 1970s. Five years of Reaganomics have raised it almost to 40 percent. That figure is not itself a disaster, but the prospect that it will rise and accelerate endlessly portends future disaster.

Proponents of the "political business cycle" hypothesis will cite the first Reagan Administration as a stunning confirmation. Nearly two years of painful disinflationary recession were followed by recovery through election day 1984. Poor Jimmy Carter had recovery first, then a new surge of inflation, then recession throughout his campaign for re-election. Reagan's success, however, was another example of his incredible luck. As argued above, the decisive demand management policies were Volcker's, not those of either President. And Reagan's fiscal contributions to recovery were unintentional. No matter. In 1984 Reagan ran on his restoration of prosperity, as if 1981-82 had occurred on some predecessor's watch. Actually the unemployment rate was the same in October 1984, just before the election, as it had been in December 1980, just before Reagan's inauguration.

WHERE DO WE STAND TODAY?

The unfinished recovery. First, the economy is still not fully recovered. The United States has done better than the six other "economic summit" nations. But unemployment is still nearly a point higher than at the peak of Jimmy Carter's recovery in 1978-79, two points higher than at Nixon's peak

in 1973, and the same as at the peak of the shortlived recovery in 1981. Utilization of industrial capacity is now 80-81 percent, compared to 85-87 percent in previous prosperities.

The decline in the inflation rate is the great victory -- it is 4 percent or even lower now, compared to 9 or 10 percent after the two oil shocks of the 1970s (year-to-year changes of GNP deflator). Persons with long memories may recall that inflation rates of 4 to 5 percent were considered intolerable before 1973 and were indeed the occasion for counter-inflationary policies. But few have quarreled with Paul Volcker's decision to declare victory in the war on inflation when it got below 5 percent. Moreover, inflation is stable or even declining; it has been well-behaved throughout the recovery. The appreciation of the dollar may be credited with as much as as one third of the disinflation of 1981 to 1985. This assistance -- the one redeeming feature of our high-interest-rate policy mix -- was borrowed from our trading partners and will be repayed in extra U.S. inflation as the dollar depreciates. However, declining oil prices -- another striking proof of Reagan's "luck of the Irish" -- are having about an equal effect in the other direction on U.S. price indexes. We are now enjoying the reverse of a stagflationary shock, a boost to domestic demand joint with a fall in prices.

The major question before macro-economic policymakers, in practice the Federal Reserve today, is whether or not to allow or engineer a demand expansion bringing the unemployment rate down to 6 percent or lower. Until recently it seemed that the Fed was content with about 7 percent unemployment, where the economy has been stuck since May 1984. Under current circumstances Volcker and his colleagues have little reason to regard 7



percent as the lowest inflation-safe unemployment rate. Last week the Fed joined Germany and Japan in lowering central bank lending rates a half point. Prior to this move, the premium of long-term bond rates over short rates had dropped more than two percentage points, apparently reflecting optimism about inflation and fiscal policy.

Prospects of deficit reduction.

Second, the fiscal-monetary policy mix is still bad, but some correction seems to be in prospect. The Gramm-Rudman drama has still to be played out, further complicated by the possibility that the Supreme Court will this summer uphold a lower court decision declaring unconstitutional the mechanism forcing automatic spending cuts if Congress and President have not agreed on a budget consistent with the prescribed schedule of deficit reduction by the beginning of the fiscal year. No one can see now how such agreement will be reached in this session before October 1, the beginning of fiscal year 1987. Congress and President are far, far apart regarding the roles of defense spending, civilian spending, and tax revenues in a budget meeting the Gramm-Rudman deficit prescription. Nevertheless, given the mood in Washington of which Gramm-Rudman is a symptom, the structural deficit is likely to be declining the next several years. The Federal Reserve will have the pleasant task of offsetting the withdrawal of fiscal demand stimulus, and one must hope that residual monetarism will not stand in the way. If recession or growth recession should occur while Gramm-Rudman is in force, the Fed will have to act with uncharacteristic boldness, because the Act's targets allow no exceptions for cyclical deficits.

The dollar is on the way down. Twenty percent more, and it will be back to its 1976-77 value. It will take some time for depreciation to improve

significantly the trade deficit. Indeed the high exchange rate of 1980-85 may have done irreversible damage to the competitive position of numerous American industries.

The failure of supply-side nostrums. Third, supply-side effects have been very disappointing to date. Obviously budget outcomes show that we were not on the wrong slope of the Laffer curve. That is scarcely a surprise. A more credible objective of Reagan policy was to shift the composition of GNP from private and public consumption to private investment, particularly business investment in plant and equipment. But comparing real Final Sales (GNP less Inventory Investment) in 1985 with 1978, the last pre-Reagan normal year, I find that more than 95 percent of the increase went into Personal Consumption and Government Purchases. In 1981 and 1982 critics of Reaganomics said that the tax cuts would result in more government dissaving than additional private saving; their warnings turned out correct. Personal saving in percent of disposable personal income actually declined from about 7 percent in the late 1970s to less than 5 percent in 1985. Personal consumption in percent of pre-tax personal income rose by one percentage point and consumer interest payments by another one.

Business fixed investment did well in the 1983-84 recovery, but, considering that it was starting from rock bottom, not strikingly better than in other cyclical upswings. The strongest gains occurred in equipment, computers and motor vehicles, for which the incentives added by ERTA were negligible. The investment boom slacked off in 1985. In any case, the growth of private domestic investment during the Reagan years was virtually equalled by the rise in the country's current account deficit. The decrease in the net claims of the U.S. against the rest of the world, now negative,

is as bad for future generations as low domestic capital formation. Private research and development expenditures have slowed down despite new tax incentives. Public expenditures on basic science and on civilian R and D have been victims of federal budgetary stringency.

There is no sign that Reaganomic measures have increased the supply of labor, corrected for normal cyclical effects. The secular downward trend in average hours of work has continued without apparent break. The labor force participation of men has actually declined; the long-time upward drift in female labor force participation has continued, but at a somewhat slower pace.

For supply-side economics the bottom line is productivity growth. Its mysterious decline and disappearance in the 1970s was the most fateful disappointment of that decade. Alas, there is no sign that it has come back. Recession and recovery have had their usual cyclical effects on measured labor productivity; after they are allowed for, the trend growth rate is only 1 percent or less. The ten million jobs added since the trough of the recession have been good news, though two million fewer than the Administration foresaw in 1981. The bad news is that the added employment has not produced as much GNP as it should have.

Greater poverty and inequality. Fourth, during the Reagan years poverty and inequality have increased in the United States. Even in 1984, after two years of recovery, 14.4 percent of persons in the United States were living in households below the official absolute poverty line, up from 14.0 percent in 1981, 11.4 in 1978, and 12.1 back in 1969. Inequality has been increasing in the 1980s, reversing modest trends in the other direction since 1960. In the two previous decades families in the lowest quintile

consistently received 5.2 to 5.5 percent of aggregate family money income; the lowest two quintiles together got 16.8 to 17.6 percent; and the top quintile between 40.9 and 41.6 percent. Now the share of the lowest fifth is less than 5 percent, that of the lowest two fifths below 16 percent, and that of the highest fifth up close to 43 percent. These are figures for pre-tax incomes. Tax changes in the 1980s have added relatively to the gains of the higher income groups. President Reagan's promise that supply-side incentives would create a "rising tide" that "lifts all boats" has certainly not been fulfilled.

Cynics like me are bound to notice that the emphasis of supply-side tax reduction and reform has been on the cutting of top-bracket income tax rates. In 1981 large tax concessions were also granted to corporations, though some of these were withdrawn in 1982 legislation and others are threatened by current tax reform proposals. The emphasis on marginal incentives is reversed in the Administration's policies toward transfer programs for the poor, where needs tests have been made more stringent and implicit tax rates (benefit losses consequent to additional earnings) have been significantly increased. In the welfare area, the Laffer curve has been matched by Murray's Law, that cutting welfare spending will reduce poverty. Thanks to his book Losing Ground, Charles Murray has become a popular favorite of the conservative convention speaker circuit, and the President appeared to embrace Murray's theory in his address to Congress in February 1986.

The President has made tax reform a high priority of his second term. Whether Congress will pass any bill acceptable to him this year is doubtful, preoccupied as legislators are with the battle of the budget and Gramm-

Rudman. The rules of the tax reform game prescribe that the outcome must be revenue-neutral; yet many members of Congress of both parties think a revenue increase is essential to meet the agreed schedule for deficit reduction.

Another condition set by the President, reaffirmed in his February 1986 State of the Union Address, is reduction of the top marginal rate of personal income tax to 35 percent. It is 50 now, and before 1981 it was 70 for "unearned" income. The bill passed by the House in 1985 violates this condition, takes away more of ERTA's business investment incentives than the Administration would like, and in several other respects is unacceptable to the Treasury and White House.

The history of this legislation is confusing and ironic. Before 1984 two tax reform proposals were before the Congress, one a Republican bill sponsored by Congressman Kemp and Senator Kasten and one a Democratic initiative by Senator Bradley and Congressman Gephardt. They were similar in lowering tax rates, broadening the tax bases, attacking loopholes, and purporting to be revenue-neutral. To gain tardily the initiative on this issue in a campaign year, the President asked the Treasury to come up with its own proposal, a task that took almost the whole of 1984 and put the matter on the political back-burner. The proposal, now known as Treasury I, was remarkably apolitical. It was prepared by dedicated experts who were committed to making the system economically neutral, not just revenue-neutral. The distortions they sought to correct were mostly provisions of ERTA, enacted by the same Administration only three years before. The anguished howls from businesses whom those provisions benefited, and from other interested parties, led in 1985 to Treasury II, a political compromise

that sacrificed the purity and incentive neutrality of Treasury I. The 1985 House bill is a different political compromise, closer to Treasury I.

If any bill is passed and signed by the President, it is likely to be an improvement over the present personal and income tax code in horizontal equity, in particular by curtailing some of the more outrageous ways in which wealthy operators avoid taxes that wage- and salary-earners cannot escape. The regressive cuts in tax rates are the political price for these reforms. Viewing the whole history since 1980, one can observe that the 1981 reduction of high-bracket tax rates was obtained without any compensatory sacrifice of loopholes, and indeed with the introduction of provisions further eroding the tax base. Given the new status quo, the wealthy now seek further reduction of top marginal rates as the price of closing loopholes that never were justified.

The public sector. Fifth, there can be no doubt, the Reagan Administration will leave the country with a smaller and weaker non-defense public sector. Essentially the federal government is well on the way out of "revenue-sharing," federal support of state and local governments' expenditures on infrastructure investments, education, and social programs. Those governments have responded partly by curtailing those expenditures, as intended, and partly by raising their own taxes, -- generally more regressive than the federal income tax.

There never was any reason to believe the Reagan thesis that the trouble with the U.S. economy was that the public sector was too big, either in its real economic activities or in its welfare-state transfers. On both counts, the United States had smaller public sectors, relative to the size of the economy, than any advanced OECD nation except Japan and Australia.

The Administration's view that only formation of physical capital by private business provides for the future of the nation is a vulgar error that sacrifices public investment in human capital (education and health), natural resources, and public infrastructure to the construction of shopping malls and luxury casino hotels.

The current conservative fad is "privatization." The Administration's budget-makers have hit upon sales of federal assets as a cute technical way round Gramm-Rudman. Obviously it is only cosmetic. But it is welcome ideologically anyway. Although some privatization may be desirable and cost-effective in the long run, the danger is that these decisions will be made on doctrinaire principle rather than on case-by-case examination of the long-run costs and benefits.

Certainly some federal programs cut or eliminated over the past five years deserved Stockman's axe, and that is true too of some of the targets of the President's proposed budget for fiscal year 1987. These expenditures would not have been vulnerable under the "business as usual" budget politics of previous Administrations and Congresses. Yet other cows that deserved slaying under free market principles have remained sacred. The most expensive example is federal agricultural policy; this Administration has spent record amounts for farm price supports and related subsidies. Another example, of interest to Canadians, is our maritime policy. In both these cases costly budgetary subventions are accompanied by regulations restricting competition.

As for deregulation, the major initiatives in energy, air and surface transportation, and finance were begun under President Carter. They have been continued and extended. The Reagan Administration's own initiatives

have concentrated less on dismantling anti-competitive regulations than on relaxing those designed for environmental and social purposes. As Canadians know, it has been hard to get the President exercised about acid rain. As blacks know, the Administration is against "affirmative action."

Missing agenda. Finally, I would mention two major economic problems that are scarcely on the Reagan agenda at all. The first is macroeconomic, having to do with unemployment and inflation. The greatest basic obstacle to full prosperity is the fear of policy-makers, at the central bank and throughout the government, and of the influential public, that a return to as low unemployment rates as we reached in prosperities in the 1970s would set off another inflationary spiral. This fear may be obsolete and unjustified, but it is a reality. If it is justified, then the inflation-safe unemployment rate is too high, 6 percent or more, and we should be actively seeking structural reforms that would lower it. These could include pro-competitive labor market policies, changes in trade union legislation, and the use of tax incentives. This is not the occasion to discuss specific proposals. I simply observe that this Administration has no concern about this crucial matter.

The second problem conspicuously missing from the Reagan agenda is the pathology of urban ghettos inhabited by blacks and other minorities. These neighborhoods, the people who live in them, and the cities where they are located have been indeed "losing ground," to use the title of the Murray book to which I referred above. It is indisputable that the War on Poverty and the Great Society did not prevent or arrest the downward vicious spirals of these areas and populations. Neither did subsequent neglect, or decline in the real public resources channeled to them. Right now the only



Administration response is to cut down further in welfare spending in the belief that this will cut down both welfare dependency and poverty. Meanwhile the lower Bronx and Harlem, Roxbury in Boston, Woodlawn and the West Side of Chicago, the Hill in my own New Haven, and similar areas of many other small and large cities are a disgraceful and dangerous contrast to the affluent styles of life displayed in the centers of the same cities and flaunted in national television.

President Johnson lost the place in history his domestic social policies could have earned him by his tragic error in embroiling the United States in the Vietnam war. His byproduct error in fiscal policy, his insistence on "guns and butter," his delay in asking for taxes to pay for the war, fatefully destroyed the economic stability achieved prior to 1966. The lesson of the Vietnam war may be saving President Reagan and the country from pushing his obsessions with communist threats in Central America to the point of U.S. military intervention. Yet he too is likely to be seen in history as repeating the "guns and butter" mistake.

President Reagan is right that the country can afford the arms buildup he has asked for. Whether it is needed, whether it is good national policy, is another question. Assuming it is needed, it should be paid for by taxing the whole country. The burden should not be placed narrowly on other government programs and their beneficiaries. A rich country can afford the defense it needs, and it can also afford the Library of Congress, public broadcasting, good statistics, environmental protection, and humane treatment of the poor and disadvantaged. Reagan's "butter" is different from Johnson's; it consists in the tax reductions he is determined to protect,

largely to the benefit of the wealthier citizens of the country. The policy has had the adverse macro-economic consequences I discussed above. It has also brought federal budget-making to the political impasse I described, ending in the colossal irrationality of Gramm-Rudman, which ironically imperils even the "guns" the President says are essential to the security of the nation and the world.

At the outset I placed Ronald Reagan in the select class of government leaders who substantially and durably shift the course of policy and the center of political debate. Yet at the end I do have some doubts about the permanence of the rightward Reagan counter-revolution. Opinion polls show Ronald Reagan's high personal popularity to be without precedent for a President in his sixth year. On very few specific issues, however, do the same polls show majorities favoring Reagan's side. In the nature of the case, an anti-government President leaves few public monuments. This President will leave none comparable to Roosevelt's Social Security or Johnson's civil rights and health insurance.

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1986-03-G Tobin, James. REAGANOMICS AFTER FIVE YEARS.