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REAGANOMICS: A PHILOSOPHICAL AND ALMOST MIDTERM PERSPECTIVE

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Evaluating the Reagan administration after 20 months in office is not an easy task. The data, good interpretive studies, the perspective of time — these are all in short supply. And when it comes to specifics, there are the usual contradictory trends within any administration. Nevertheless, there is a philosophical position in economic policy that the Reagan administration stands for and that I will try to articulate. I think understanding that philosophy is at least as important as examining specific policies and their effects. If the administration is in office long enough, the philosophy and the policies will converge.

I believe, also, that the economic philosophy of Ronald Reagan has its roots in a particular historical perspective. We will find it useful to begin by taking a backward glance at the American economy, from which we will draw Reaganite interpretations. This exercise is important in rendering any kind of judgment on the success of this administration and its major policy initiatives, now and in the future.

An Historical Sketch

In the mid-1770s the United States was a country of 0.8 of a million square miles and 2.5 million people, most of whom — 90 to 95 percent — were engaged in farming. In 1976, two centuries later, our total area was 3.6 million square miles — 4.5 times greater — and our population was 215 million, of whom only 8 million or 3.8 percent were living on farms. Of these 215 million, about half were descended from the original 2.5 million; the other half, from immigrants who came in great waves mainly between the 1830s and the early 1900s. (This and the next four paragraphs draw on Kuznets (17).)

The best evidence we have on U.S. per capita real income is that it increased during these two centuries by a factor of 12. That is, in 1976 the average American had an income, corrected for inflation or deflation, that was 12 times greater than the income of the average American in 1776. Changes in the quality of commodities consumed make long-run comparisons of income, such as this, rather imprecise. But it is safe to say that the 12-fold increase represents at least a lower bound

to the increase in goods and services available to the average American after the first two centuries of the republic.

Now, we can gain a rough measure of the growth of the entire economy — of the GNP — by combining this information on the growth of population with the growth of per capita income. If we simply multiply the factor of increase in population — from 2.5 to 215 million or an increase of 86-fold in the number of "capitas" — by the 12-fold increase in income per capita, the capitas cancel out and we are left with 86 × 12 or approximately 1,000 as the factor of increase in income or, equivalently, GNP.

On a first approximation, we can say then, that our economy today is 1,000 times greater than it was in 1776. Is this a remarkable accomplishment and if so, in what sense? The compounded annual growth rate of the GNP is not itself remarkable — 3.5 percent per year. The U.S. personal saving rate has never been extraordinarily high, averaging, along a constant trend, about 6.5 or 7 percent of disposable personal income, though undergoing wide fluctuations around that average. Nor is our present measured per capita income unusual — many of the advanced countries — Canada, Australia, those of Northern Europe — approach it (Kuwait, in fact, exceeds it).

What is remarkable about the American experience is the high growth rate of the population — 2.25 percent compounded annually — and the sustained growth of per capita income at 1.25 percent compounded annually. An enormous number of people, starting with a mere 2.5 million, entered into the American growth process and enjoyed its fruits. While the American population was increasing by a factor of 86, that of Europe was increasing only 4-fold. And the American growth was especially noteworthy for the incredibly diverse ethnic and cultural background of its participants, most of whom were able to blend into the American mainstream without losing their individual and group identities.

Several other features of U.S. economic development are relevant to the contemporary debate:

- The growth process was not accompanied by increasing inequality of income distribution. The best data we have seem to indicate that the degree of income inequality, as reflected in unadjusted money incomes, was more or less constant throughout our history. Even though our unadjusted money incomes are far from equal, constancy in the degree of inequality in the face of continuing growth is itself a momentous fact. It means that all groups were pulled along by the growth process; that, in John F. Kennedy's phrase, "all ships rose with the tide." Today's poor, today's rich, and the contemporary middle class are all about 12 times better off economically than they were 200 years ago. (17)

• In fact, there is considerable evidence that, taking account of appropriate adjustments to money income, the degree of income inequality has been sharply reduced since at least World War II, and probably 1929. Nonmonetary government transfers — particularly foodstamps, housing subsidies, and health services via Medicare and Medicaid — appear to have accomplished a significant measure of redistribution toward the lower incomes. (2,3) Moreover, when one takes account of postwar demographic changes, such as the fact that the lower income earners are to a much greater degree than previously the very young, the old, and female-headed families — all traditionally low earners — the income distribution takes on a much more equal cast than it ever has before. Equally noteworthy is the fact that family size and the number of wage earners are both higher for the highest income quintile of families than for the lowest quintile of families. I have told my students for some years now that the quickest way to enter the top income quintile is to be part of an intact family whose head is over 25 and under 65, and to make sure that one's spouse is employed and one's daughter has a paper route. (3)

• Among the major factors driving the growth of real income in the United States is technological change. Estimates by various economists, using widely diverse methods over a variety of time periods, point to technological change as the source of 40 to 50 percent of the growth of per capita real income. (7, 15)

• Throughout most of our history, the development of the American economy has been accompanied by a falling general price level. Given the usual caveat in making such comparisons, the consumer price index was no higher in 1948 than it had been in 1812. Until the 1970s, the only periods of sustained inflation had been those of wartime. Apart from occasional and minor bursts of inflation in the 1950s (the Korean War) and the late 1960s (the Vietnam War), it is doubtful that a general price index which took account of product quality changes would show that any inflation had occurred in the post-World War II period prior to the early 1970s. (18, p.19)

• Unemployment, as a fraction of the labor force, has historically been high, even by modern standards, running 4 to 5 percent in the 1860s, 10 percent in the 1870s, 4 to 5 percent in the 1880s, 5 to 20 percent in the 1890s, 5 to 10 percent in the 1910s, 20 percent in the 1930s, and 5 and 6 percent in the 1950s and 1960s. This is partly a result of the high levels of immigration, partly because of frequent lapses into recession or depression. (18, p.22)

• If we measure the stability of the economy by the frequency of these recession years, the American economy has become more stable in the post-World War II period than it was before. In the 79 years from 1866 through 1945, we were in a National Bureau-designated state of recession 30.5 years or 39 percent of the time; from 1946 through the third quarter of 1982, the recessions add up to 8.5 out of 37 years

or only 23 percent of the total time interval. I attribute this improvement to the adoption of automatic fiscal stabilizers and to increased stability of the money supply due to deposit insurance and an improved Federal Reserve performance.

To summarize the growth process: In the first two centuries, the American surface area increased 4.5-fold and the population — both because of a high birth rate and significant immigration — increased 86-fold; the economy switched from largely agrarian to largely nonagrarian and increased in size 1,000-fold; technological change accounted for almost half of this growth; real income per capita rose 12-fold across all income groupings; income inequality did not increase and, in fact, when adjusted for nonmonetary transfers and demographic changes in recent decades, was significantly reduced; until the 1970s, sustained inflation has occurred almost exclusively in wartime; unemployment ratios have reflected the high immigration rate and frequent business fluctuations; cyclical instability has been sharply reduced in the post-World War II era.

The Importance of the Individual

The Reaganite interpretation of American economic history stresses the role of the individual in a decentralized decision-making process. Whether as consumers or producers, a free people are influenced but not subjugated by their cultural and social environment; they pursue self-interest, seek information, make mistakes, learn from their mistakes, weigh costs and benefits, and respond to market-transmitted incentives. Everybody gains from the resulting trades.

To the extent that property rights are secure, people and capital will be mobile, individuals will invest their savings, and the masses will emerge from poverty on a grand scale. Knowledge, including new technology, will burgeon, spurred by the efforts of thousands of competing individuals seeking, in a constant trial-and-error process, to maximize their own rewards.

I think both Adam Smith, whose profile graces my tie, and our founding fathers foresaw this enormous potential in a free economic system. They believed that the fruits of economic activity would be widely shared; that commercial transactions, while not particularly meritorious, as such, were a more desirable outlet for human endeavor than national or religious goals prescribed by central authorities. (16) I do not think James Madison would have cared much for JFK's admonition that the people ask themselves what they can do for government.

The Role of Government

But government, of course, does play a crucial role in setting and enforcing the laws of a free society, including the ground rules for economic transactions. This includes the preservation of competition,

and the internalization of externalities, which are costs and benefits that parties in private exchanges — for one reason or another — ignore. At all times, however, government should follow the free market credo and do only what it can do better than the private sector.

Thus, while government can play a positive role in enforcing anti-trust laws and regulating natural monopolies, there is always a danger that government will apply anti-trust against ultra-successful competitors, such as A&P and IBM; regulate industries, such as railroads, producers of electricity, and suppliers of long-distance telephone service, even after new technologies have deprived them of their monopoly power; or regulate industries, such as trucking, buses, barges, and airlines, which seem never to have had any, or very much, monopoly power, even at their origin. In a word, the existence of market failure always has to be balanced against the possibility of even greater government failure.

Externalities. Classic examples of externalities are environmental pollution, which occurs because individual property rights in the environment are so weak, and national defense, which is a public good. A public good is usually defined as a good whose benefits are predominately external and which will thus not be produced in socially desired amounts unless government intervenes. Another public good is macroeconomic stability, which the private sector has no incentive to supply. And, finally, income equality, which tends not to occur in the private sector, may be regarded by the electorate as a worthy goal, one that only government will be able to provide in the desired amount.

As with the regulation of monopoly, the response by government to externalities can be counterproductive. Schooling, designed to produce a common language and culture, had strong positive externalities in the 19th and early 20th centuries, when immigration was at its peak. Publicly provided schooling clearly met the need during that period, and perhaps beyond. But government enterprises tend to shut out competition, and in recent decades public schools have become an egregiously uneconomic and unresponsive bureaucracy. The time to break up the local school monopolies (which will invariably weaken the attendant teacher-union monopolies) and replace them, perhaps, with an educational voucher system, has arrived.

In spite of positive externalities in universal low-cost postal delivery, it was almost certainly a mistake from the beginning to grant government the first-class mail monopoly. The technological backwardness of the labor-intensive postal service, in this age of computerization, boggles the mind.

Government as Pork Barrel. The general problem, as we all know, is that government favor becomes a socially unintended alternative to market outcome. Organized groups may be able to improve mightily on their market-determined shares by putting the heat on their regionally elected representatives. Unorganized individuals may seek

out and find endless sources of government largess.

Whether it be protection from foreign or domestic competitors by tariffs and taxes, overt subsidies, covert guarantees, government contracts, government jobs, licensure, environmental regulation, rate of return regulation, or that abomination of our time — command and control regulation — the gain to individual supplicants can be huge, while the per-capita social efficiency loss of each incremental government intrusion or response is small and therefore tolerable. But the aggregate loss is cumulative and, over time, potentially overwhelming.

The Case for Income Redistribution. None of the above should be taken as a denial of the legitimacy of conscious and above-board income redistribution as a social goal. While some may see market outcomes as those of a meritocracy, others may perceive a larger, rather than a smaller, element of luck in the results, which are therefore not sacrosanct. And regardless of luck, one may regard the direct market rewards and punishments as too severe. (24) The difficulty, however, is that while we know something about our growth process, we know very little about how to influence the progress of whole ethnic or social groups. The risk of doing more harm than good is not small.

An Alternative Model of Human Nature. The only way to understand much of the command and control variety of regulation, as well as any number of other proposed and de facto government economic interventions to which Reaganomics is a reaction, is to examine the extreme interventionist view of human behavior. That view stands at opposite poles to that of Adam Smith, the American founding fathers, and what I prefer to think of as the characteristic Reaganite perception. The extreme interventionist view denies the premise of free and reasonably informed human action; it presumes that consumers, workers, and "small" business people are passively influenced by the self-serving decisions of large corporate enterprise which, through advertising, control of the media, and various other manipulations, determines consumer tastes, wages, and working conditions. (12) Market demand and labor supply curves have no independent status. They are fixed by external forces and can and should be dislodged only by government mandate.

This view of the market economy, of the breakdown of participatory, Smithonian economic democracy, stands in stark contrast to the usual view of political democracy. In the political realm, these same individuals who are helpless victims of their economic masters are believed able to cope, somehow, when they cast ballots instead of dollars; to do so with reasonably good judgment, incomplete but adequate information, and a long-run ability to see through most of the abuses of the truth committed under protection of the First Amendment. (5)

The Regulatory Approach and Its Hazards. The view that the people have simply failed in their exercise of economic freedom and therefore

deserve to lose it is at the root of any serious centralized alternative to the free market economy. Whether it be idiot consumers or exploited workers, a benevolent government, miraculously free of any perverse incentives or misperceptions of its own, must rescue the people and impose appropriate standards, such as safety in the workplace, safety and demonstrated effectiveness in pharmaceutical products, safety in automobiles, and "affirmative action" — a kissing cousin to quotas — in employment. Government must redirect capital to new energy sources, mass transit, and daycare centers. Government must develop low-cost housing, underwrite health services and provide old age insurance, determine the minimum compulsory age of retirement in public and private employment, and furnish public service jobs to those who cannot find them in the market economy. In a word, there isn't anything the government can't do better than the private sector.

A conceptual failure inherent in these kinds of government initiatives is, of course, their premise that most people cannot handle their economic freedom and are not responsive to economic incentives. It is a false premise. The result is that endless government programs suffer from that aptly named economic malady, moral hazard. Moral hazard refers to the tendency of private or public measures designed to achieve certain objectives to promote, through perverse incentives, the very opposite of what they intend.

Thus government-subsidized flood insurance lowers the cost of new construction on the flood plains and so encourages it among rational, cost-conscious citizens; auto safety devices reduce the cost of accidents and thereby promote reckless driving; safety and effectiveness regulation of drugs imposes severe punishment on regulators who approve defective drugs and ignores the costs of delay in introducing effective drugs, thereby creating a review process so protracted that more lives may be lost than saved by any improved features of the drugs; (27, pp. 28-29) government-subsidized health services are provided at low, third-party-funded costs, fostering vastly increased use of such services; unemployment benefits lower the cost of unemployment and generate unemployment; (9) anti-poverty programs create poverty and dependency; requiring employers to pay greater workmen-compensation benefits reduces the cost of accidents to workers and increases the industrial accident rate; (4, pp. 45-46) granting air traffic controllers generous retirement benefits based on stress on the job, where stress was defined as responsibility for near misses of aircraft, resulted in a statistically significant increase in near misses; (28) and on and on and on.

An early pioneering study by Sam Peltzman indicated that the 1962 Amendments to the Food and Drug Act, strengthening safety requirements for drugs and requiring proof of their efficacy, created a review lag that is nothing less than a national scandal (the average lag is now 8 years). (25) There was, moreover, no identifiable increase in drug effectiveness, the primary goal of the amendments.

Peltzman also argued, from the data, that the mandated auto safety standards were promoting what he euphemistically called more "intensive" driving and a consequent higher accident rate. Occupants of cars were indeed surviving at a higher rate in view of the safety features, but pedestrians and bike riders were dying in increased numbers about equal to the reduction in occupant fatalities. (26)

I used to caution my students that the studies by Peltzman and others were only the first word on the subject, not the last; the econometric techniques could be improved; and time would tell how well the variables had been controlled. Well, for a long time Peltzman and his colleagues had the only word on the subject. In time, criticisms appeared and misspecifications were uncovered in the original formulations, but the broad conclusions of these studies have generally remained intact. (31) The social reformers have a great deal to answer for. If I were a demagogue, I would say they have blood on their hands.

Even in the absence of moral hazard, government agencies are simply unqualified to carry out the myriad tasks assigned to them. Government efforts to counter the decline of the cities have been utterly uninformed, oblivious to the underlying mechanism that might be transforming the cities. Ignoring the forces that propel populations out of the cities and from one region of the country to another has resulted in government's utter failure to reverse or ameliorate the process, in spite of endless expenditures.

I have seen no evidence that agricultural programs have stabilized farm income over any extended period of time; that farm price supports have helped poor farmers instead of rich ones or done anything but delay temporarily, at considerable expense to taxpayers, the inexorable movement of resources off the land.

Reaganomics: Regulatory Reform

I do not mean to suggest that dissatisfaction with proliferating government programs which could not pass a simple cost-benefit test was an exclusive Reaganite insight. On the contrary, the first stirring of regulatory reform began in the aborted second Nixon administration, which itself had been responsible for some of the worst command and control regulation of the decade — the Clean Air Act of 1970 and the creation of the notorious Occupational Safety and Health Administration in the same year. Under Gerald Ford, regulatory reform gained momentum among the young economists of the Council on Wage and Price Stability (COWPS). And then, because the deregulation of transportation had become a bipartisan cause, the regulatory reform movement came to fruition under Jimmy Carter. A good part of the reason for this development was the man Carter chose to head the Civil Aeronautics Board (CAB), the agency responsible for rates, routes, and the privilege of supplying interstate air transportation. The man, of course, was Alfred Kahn, who shares the platform with me this morn-

ing. Kahn lost no time in granting the airlines whatever freedom to determine rates and routes was permitted under the law. He boldly went about dismantling the government-controlled cartel of air transport, which, in its 38 years, had refused to accept a single new entry to the industry, in spite of hundreds of applications. By 1978, Congress had passed enabling legislation to complete the job, establishing a time table for the total phaseout of the CAB. I believe this was the first major peacetime government agency to be dissolved — not merely transferred to another department.

Fred Kahn did not himself complete the task at CAB, having been asked to chair COWPS in 1978. But his able successor, Marvin Cohen, presided over the remainder of the dismantling operation. In 1979 another disciple of Fred's, Darius Gaskins, who had been at the CAB but was then my own boss in the Energy Policy office, was appointed chairman of the Interstate Commerce Commission (ICC), whose regulatory scope extends to railroads, trucks, and interstate waterway transportation. Gaskins had little more than a year on the job to start dismantling the federal surface cartels, and he did so with intelligence and vigor.

However, the deregulation was unfinished when Carter left office and it fell to the new administration to continue it. Under the Reagan-appointed ICC chairman, Reese Taylor, a man acceptable to the Teamsters, there has been a decided slowing down in the decontrol pace and much wringing of hands by free-market economists who monitor these things. (23)

The President's swift handling of the Air Traffic Controllers' strike in August 1981 was a commendable action whose ultimate payoff will be considerable. Public employee unions, such as those of the postal workers, have driven wages well above competitive private-sector levels. (1) One negative aspect of the government's firing of striking air controllers, however, has been the partial reregulation of airport traffic and airline routing as part of the adjustment to temporarily reduced air traffic control capability.

Environment, Energy, and Natural Resources. There have been other deregulation disappointments thus far in the Reagan administration. The Environmental Protection Agency (EPA) has begun to show some desired flexibility in determining specific pollutant emission levels, but has basically continued to perpetuate detailed uniform standards for existing sources and uniform technology-specific standards for new facilities. There has been little progress toward a decentralized market-based system of emission charges or, where feasible, marketable pollution rights. (6) Either of these techniques would permit firms for whom the cost was lowest to carry out the lion's share of abatement with technology of their own choosing.

The Clean Air Act is the supreme bureaucratic law, mandating standards for thousands of different pollution sources that differ with

respect to endless characteristics, such as regional location, age of the equipment, and the surrounding air quality. The administrative task is so horrendous that the EPA has been unable to establish all the standards, as yet, or develop adequate enforcement procedures. The present administration has hardly begun to develop the initiative of the Ford administration, which allowed firms to buy pollution rights from other firms in dirty air regions, leaving the total emission level unchanged; or the "bubble" policy of the Carter administration, which allowed a given firm to allocate a constant total amount of emission among its separate plants, as it sees fit. Both initiatives have been shown to save firms many millions of dollars.

One of the most positive deregulatory actions taken by the Reagan administration was its removal of the remaining controls on oil prices and allocations in January 1981. I will not recount the details of our long nightmare with oil price controls and allocations. But since I was personally involved with them, let me only remind you that the controls taxed domestic oil, subsidized imports of oil, subsidized small inefficient refiners, and imposed Byzantine mandatory allocations that bore no resemblance to optimal petroleum use or to any elementary notions of equity.

Once again, the initiative for decontrol began under the Carter administration, which, under the law, began a gradual 30-month phaseout. The decontrol was combined with the windfall profits tax — actually an excise tax — which I felt was overdone. For one thing, it should never have been applied to newly produced oil, and the legislation by Congress last summer to reduce the tax on new oil by one-half is a desirable amendment.

As almost his first official act, President Reagan pulled the plug on the eight months remaining on the oil controls and did us and the entire free world an enormous favor. If only he could have contrived to do the same thing for natural gas prices! There has, however, been no movement to accelerate the slow and painful deregulatory process of natural gas.

Meanwhile, a little over a year later, the President successfully vetoed a Republican-led attempt to reimpose the oil regulations as a standby emergency measure. But what the President failed to do was to embrace a competing bill, sponsored by Senators Bill Bradley and Charles Percy. That bill urged the avoidance of oil controls under any circumstances and required the president to move aggressively to build up the Strategic Petroleum Reserve, design a strategy for its drawdown, and prepare a plan for recycling windfall-profits tax revenues to low-income families. What the administration has not faced up to is that it takes more planning to avoid intervention in disrupted markets than it does to intervene. The non-intervention has to be planned in every feasible detail and simulated with respect to likely consumer, producer, Congressional, and media reactions. There is no other prac-

tical way to preserve any free market in the face of severe external shocks. (13)

One of President Reagan's finest hours was his early decision to withdraw from the tentative agreement on the Law of the Sea and then, this year, to renounce the final document. The Law of the Sea governs the mining of minerals on the world sea bed and arranges for the distribution of a portion of the revenues among Third World countries. As drawn up during a 16-year period by an international commission to which four administrations — two Democratic and two Republican — sent representatives, the Law of the Sea establishes a highly paid bureaucracy in Switzerland, sets strict production quotas on the minerals, fixes prices, and transfers eventual billions in revenues to the governments of the less developed world. It creates, potentially, a super cartel that could dwarf anything the world has ever seen. How lucky we are that there was not some nice guy running the State Department who could urge another nice guy in the Oval Office to sign it.

I know less about land use policy, but I do have an inner conviction that U.S. governmental units hold far too much territory — more than one-third of our land surface, by one count. I do not believe the federal government in this century has been a trustworthy steward of the land, allocating it to its most valued uses. By opening wilderness and offshore areas to oil, gas, and other minerals exploration, James Watt is moving in the right direction. Given the rarity of big mineral finds, it is important that large areas be put up for lease. What counts is that the private sector have an opportunity to evaluate areas as large as possible — areas, which it is not, in any case, likely to lease in overwhelming amounts.

Other Deregulatory Initiatives. There have been other hopeful signs of the resurgence of economic reasoning in regulatory policy. The Federal Trade Commission is trying to establish a rational course which fulfills its anti-trust mandate while avoiding the anti-advertising zealotry of the Carter team. The Consumer Product Safety Commission has been curtailed, and I believe, for good reason, since its aggregate effort is unlikely to pass a cost-benefit evaluation. (32, p.25) The National Highway Traffic Safety Administration has sought to limit some of its dubious previous initiatives, though was recently overruled on the air bags by a court decision. The Justice Department dropped its long festering case against IBM, allowing full competition to return to that industry. Ma Bell has been dismembered, more or less, curtailing its monopoly and opening the door to more competition in telecommunications, though not, I think, as much as was possible.

Overall, the Reagan record on deregulation or regulation — where called for — of industry and natural resources has some pluses and minuses. The pluses are important — the government is essentially out of the conventional oil business, it has squelched the notorious

Synthetic Fuels Corporation and the general push to nuclear energy — both of which are simply uneconomic — and put some rationality into anti-trust. But the minuses are also significant — the failure to proceed swiftly with surface transport deregulation, to turn EPA into an economically based activity, and to accelerate natural gas decontrol.

Having said all that, I think we should take the administration's claim seriously that it has reduced the size of the monthly Federal Register, the compendium of all newly issued regulations, to a shadow of its former self. That is an accomplishment, which, in the long run, will match and perhaps surpass Jerry Ford's 53 glorious vetoes and the New Deal-type initiatives that made no sense in the 1950s and which Dwight Eisenhower never permitted to see the light of day. We'll never know, but should always appreciate, the endless mischief that the Departments of Energy, Education, Labor, and Housing and Urban Development — to name only four — could have promulgated in a friendlier environment, but weren't permitted to.

Reagan Macroeconomics

I've left the toughest part for last. In its first 20 months the Reagan administration has been preoccupied with inflation, budgetary deficits, astronomical interest rates, and high unemployment. These macro magnitudes all supersede regulatory issues in the minds of the voters; bringing them under control is no less consistent with the circumstances of our economic development of the past two centuries. Ronald Reagan had made an issue out of all of these variables in the 1980 campaign, promising to reduce them all, along with taxes, while at the same time increasing defense expenditures.

I don't know if anyone really believed that it was possible to accomplish these goals quickly and simultaneously. But the political rhetoric played down the tradeoffs — for example, between inflation and employment that is involved in an anti-inflationary policy. Ideological support from supply siders and expectationists filled in remaining holes in the argument to produce the following scenario: The tax cuts, involving both consumers and producers and average and marginal rates, would stimulate greater work effort, saving, and investment. These in turn would generate income and offset a good part of the loss of tax revenues, as claimed by the Laffer hypothesis.

Moreover, discretionary federal spending would be pared to the bone to balance the increase in defense spending and contain any remaining deficit. Should the deficit, nevertheless, temporarily balloon, monetary tightness, already in force, would be maintained to keep the inflation in tow. However, interest rates, which are sustained at high levels mainly by inflationary expectations, would plunge as savers, borrowers, and wealth holders all quickly responded to the administration's vigorous pro-supply and anti-inflation posture.

I'm not sure anyone expected everything to fall into place without a hitch. Few expected the President to push a substantial tax cut through the Congress in his first year. Even fewer believed that spending could be reduced to a significant degree, particularly with the rise in defense spending that the voters wanted and were likely to get. I think a lot of people believed, however, that if taxes could be cut, this would act as a constraint forcing Congress sooner or later to curtail spending.

When, in the early summer of 1981, it seemed as if the President might indeed get his tax cut, the prevailing commonsensical view was that each building block in the President's program should be pragmatically accepted and the next installment sought in its turn, not before. This seemed particularly justified by the fact that the negotiated tax package and the rise in defense spending would take several years to be fully effective, giving the administration ample time to hack away at the social programs and the general pork barrel.

The tax package finally agreed upon reduced the maximum marginal rate on individual income from 70 percent to 50 percent and the withholding rate on all individual income 5 percent in fiscal 1982 and 10 percent in both 1983 and 1984. Business tax relief took the form of more rapid write-off for capital equipment and a liberalization of the investment tax credit.

While the personal tax reductions were significant, their impact was more or less fully offset by the simultaneous increase in the inflation "bracket creep" for the majority of taxpayers plus the scheduled increase in Social Security taxes. (21) However, an important — perhaps the most important — feature of the act, which goes into effect in 1985, ends bracket creep by indexing the income tax brackets and the personal exemption — i.e., adjusting them annually for inflation.

By the late fall of 1981 it became clear that the economy had entered a new recession four or five months earlier and the new tax law was having no effect on long-term interest rates, which remained at historic high levels. Short-term rates fell moderately, as did the prime rate, but all three remained incredibly high, even after subtracting the inflation rate.

At the same time, the recession and the interest rates being paid on the federal debt — not the tax cuts — were together causing the deficit to mushroom. The 1980 deficit had been $60 billion, but for fiscal 1982, the deficit was running at more than twice that amount and will, in fact, be about $115 billion for the fiscal year ending this month. While deficits in a recession are not a bad idea, the projections by almost everyone for the next three years in a moderately recovering economy placed the annual deficit at $150 to $160 billion or more. This terrified government economists and absolutely panicked the director of the Office of Management and Budget who was transformed into a Keynesian on the spot!

Martin Feldstein has calculated that a likely deficit in 1984 of $160 billion will equal 4 percent of a $4 trillion GNP. (10) He attributes half of that deficit to the deficit of 2 percent of GNP which the administration inherited when it took office. Of the remaining 2 percent, 1.5 percent is explained by the 1981 reduction in business and personal taxes (.75 percent due to each). An assumed 7 percent annual increase in defense spending would increase the 1984 deficit by 1 percent of the GNP, but Feldstein assumes that cuts in nondefense spending offset half of that. Feldstein proposed delaying the July 1983 10 percent tax cut over an additional year or two, but not otherwise altering the 1981 law.

In the summer of 1982 the administration and Congress chose instead to raise taxes by, among other things, requiring withholding of dividends and interest, taxing telephone calls and cigarettes, restricting medical deductions, limiting the investment tax credit, repealing the further accelerated depreciation scheduled for 1985 and 1986, and repealing the ability of companies with unused tax credits to transfer them to other firms through equipment leasing. This act was estimated to raise $98 billion by 1985, and more beyond that. It offset about a fourth of the 1981 cuts. However, it left intact the 1981 individual income tax reductions and most, but unfortunately, not all of the business benefits while tilting toward consumption taxes and tighter collection procedures.

The effect of the tax increase will, of course, be to reduce consumption and increase saving, out of which a portion of the government deficit can be funded. This will leave more saving for current investment. While taxes are not ordinarily raised in a recession, doing so now enables the money supply to be loosened somewhat and interest rates to decline. This tradeoff between fiscal and monetary anti-inflationary polices provides a welcome measure of monetary relief.

A Macro Evaluation. How do we assess the administration's macro policies in light of our history and what I have identified as the Reaganite interpretation of that history? Clearly the government budget, like the impact of government regulatory policy, had gone well beyond anything that might be recognized as an externality in the private sector. One can make a case for the payment of unemployment compensation and food stamps to individuals whose jobs are temporarily lost in cyclical downturns or in swings in international comparative advantage. In fact, a simple negative income tax, for all its demonstrated negative incentives, would certainly be an administratively superior and less costly approach to all such subsidies, including welfare and other income redistributive measures.

But the bulk of government budgetary activity has demonstrated government's inability to function in a controlled and disciplined fashion. Civil service and military pensions are a scandal. Social Security has become the largest grab bag of all, over-indexed, overly generous

to those in the system for comparatively short periods, and oblivious to major demographic changes that are under way. The private sector could have done it a thousand times better. Federally subsidized Medicare and Medicaid have thrown fiscal control and individual responsibility to the winds in a sector that, contrary to mythology, could function competitively, like any other, in the absence of restraining regulations — both public and private. There are a myriad of federal spending programs in education, transportation, and housing that make no sense at all.

Has Reagan macroeconomics fumbled the ball? I don't think so. Twenty months into the administration we have a $115 billion deficit, which is just about right for the recession we are in. We have gotten some tax reform for individuals and businesses that will eventually count for a great deal. The efforts to trim the budget have not made a serious inroad into the social programs and other dubious expenditures, but at least many of the outlays have stopped growing — more than we realize, as anybody (like myself) who feeds on government research contracts surely knows. And the underlying inflation rate has dropped smartly — from 9 and 10 percent in 1979 and 1980 to 5 percent and under in 1982. That is a major accomplishment, one that this and the preceding administration, through its initiation of the tight money policy, can claim credit for.

If anything went wrong, it was a failure to understand the underlying macroeconomics, while building up naive expectations about what the policies could be expected to accomplish in a short period of time. The supply siders and Lafferites may have a piece of the truth, but no sense of time dimension. We don't really know whether lower personal taxes and higher disposable incomes, on net, increase work effort or the savings ratio. Economists have known for years about the backward bending labor supply curve, whereby households may respond to higher earnings by working less and enjoying more leisure.. The savings ratio, as I noted earlier, fluctuates around an incredibly constant trend under the most diverse circumstances. (30) And while the absolute level of investment will eventually respond to accelerated cost write-off, one should not anticipate very much new investment while industry is still operating at 70 percent of capacity.

The belief that interest rates are primarily an expectational phenomenon and would plunge as soon as the 1981 tax cuts were passed was obviously wide of the mark. As Feldstein (11) has pointed out, the impact of inflationary expectations on interest rates and other variables is a very gradual process. In addition, interest rates are determined by many things, not the least of which is the rate of monetary growth. Short-term rates, in particular, which are little influenced by expectations of any kind, are heavily influenced by monetary policy, which, since the beginning of 1980, has been on the longest course of stringency in the postwar or probably any other period. The tax cut,

without major spending cuts, was hardly a basis for revising inflationary expectations downward and thereby exerting downward pressure on the long-term rate. Moreover, when one looks at the 1981 deficit, adds in off-budget federal borrowings and federally-guaranteed loans, the grand total comes to 79 percent of total savings, the highest such percentage in 20 years and possibly in history. (19) There is no mystery about the level of interest rates or their failure to fall rapidly.

The Role of Monetary Policy. The major macro policy of this administration and the preceding administration, in its last year, is, of course, the tight money policy. In 1980 the money supply failed, for the first time in perhaps 20 years, to rise responsively with the federal deficit and the rise in federal-related borrowings. (20) The great monetary restriction had begun.

While I am not a narrow monetarist, the fact remains that persistent inflation, even if not caused by monetary expansion, can be brought under control by a slowing of the monetary growth rate. This is a particularly effective method in our political system in which the Federal Reserve is insulated from political pressures and the only alternative, fiscal policy, is a very inflexible tool.

Moreover, whatever policy we use to curtail inflation, there has never been a recorded instance in which the anti-inflation policy has failed to create recession and unemployment in its wake. The reason is simple. As Herb Stein (29) explains it: if total spending has been rising at 12 percent per year, with the price level rising at 9 percent and output at 3 percent, a slowdown in spending to 5 percent would, ideally, reduce the inflation to 2 percent and permit output to continue to grow 3 percent. In practice, however, the inflation rate would fall much less than the ideal 7 percent, owing to contractual obligations and informal commitments to price and wage increases that reflected the previous experience with high inflation. The reduction in money and spending would thus fall disproportionately on real output and employment, the more so the greater the monetary contraction.

There is, unfortunately, no effective way to avoid the recession. Those who assert that we are using unemployment to fight inflation are being demagogic. The fact, rather, is that the attempt to bring inflation under control in virtually every instance and every country that has ever tried to do so has resulted in an unavoidable lapse from full employment. (22) We simply don't know how to prevent the induced recession. We might, of course, impose a very gradual monetary restriction which would attempt to bring the inflation under control with minimal impact on economic activity. It is, however, very unlikely that such a policy would be maintained for the requisite period or that the private sector would find the government's anti-inflation posture very persuasive. We could, at the other extreme, make the monetary contraction so severe as to try to get the job done more quickly. But this risks a cumulative downturn and puts all politicians instantly out

of office, those not subject to immediately-scheduled elections being impeached or recalled. (29)

There is, finally, a third alternative, which is to impose wage and price controls or an incomes policy with teeth in it during the monetary contraction. In principle, this is not an illogical policy. It is the only circumstance in which general controls or guidelines make any sense at all: the ongoing rise of demand is being slowed and the supply side of the system needs to learn quickly that its old pricing pattern is no longer appropriate and, if pursued, will cost it dearly. One way to communicate that fact is to impose a policy that simply restrains the general increase of wages and prices. The problem, of course, is that we have rarely, if ever, been able to use controls in so well-targeted and selective a manner. The 1971 freeze was utterly uncalled for and served simply to mask rising demand forces, and later to impede the adjustment of the economy to the world energy shock. I don't feel that the Carter incomes policy was any more successful, serving in 1979-1980 to inhibit resource reallocations that would have mitigated the second energy disruption. In view of the energy shock, I also think it was a mistake to initiate tight money in 1980. Independent supply-side disturbances, such as an energy shortfall, should be accommodated by a somewhat looser, not tighter monetary policy.(14)

Incomes policies, in practice, are just too blunt, too inflexible, and ill-timed. They have ended up doing more harm than good. In brief, the government failure of incomes policies exceeds the market failure — the recession — caused by tight money.

I think the administration should stick to its guns. The recession is bad, but not as bad as the popular perception of it. To compare the current 9.8 percent unemployment rate in any way to the 1930s is misleading. Today we are several times more affluent, we have unemployment insurance, and 57 percent of the working age population are employed, compared to just over 58 percent before the recession. In 1933, there was no insurance and only 44 percent had jobs, relative to 57 percent in 1929. (8, pp.266-268)

The Reagan macro policies have bought us time, while achieving a significant reduction in the inflation rate and a good start on tax reductions and tax reform. In the future we will either modify our entitlements programs to make them affordable or we will have to raise taxes or give up on the anti-inflation effort. Once this fall's election is over, Ronald Reagan will have another opportunity to lead the way to budgetary discipline, and responsible members of both parties will again provide the necessary support.

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