Twenty-Five Years of Reaganomics: Successes, Failures, and Lessons

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When Ronald Reagan came to Washington in 1981 he brought with him a conservative school of economics, founded on decades of personal study, writing, practical experience, and association with academic economists, several of whom he brought with him as officials and advisers. The conservative school emphasized—much more thoroughly and systematically than those associated with previous presidents of either party—the economic advantages of private markets, the disadvantages of government spending and regulation, and the importance of private economic incentives in advancing or undermining government policies.

The distinctiveness of Reagan's approach to economic policy had been clear from the beginning of the 1980 presidential campaign, when his opponent in the Republican primaries, George H. W. Bush, had dubbed the approach "voodoo economics." Although Reagan invariably characterized his proposals as a return to the sounder policies of an earlier era, he cheerfully embraced the notion that he was leading a conservative revolution against 50 years of welfare-state policies beginning with the New Deal, and this was a steady theme of his political opponents and media commentary throughout his tenure. When his tax proposals passed the Congress in August 1981, *Newsweek* magazine led its cover story:

> . . . Ronald Reagan led the toasts last week to the end of the half-century liberal era in American Government—and the triumph of his own astonishing 190–day counterrevolution. His radical package of tax cuts had just sailed through the Republican Senate on an 89–to–11 breeze and cleared the Democratic House in a stunning 238–to–195 upset. His $35.2 billion assault on the Federal budget was safely on track toward his desk by the weekend. His opposition lay broken before him . . .[1]

And Reagan was always quick to acknowledge the intellectual antecedents of his policies. Toward the end of his Administration, when the economy was growing strongly following several recession years, he said,

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[1] "Rest in Peace, New Deal," *Newsweek,* August 10, 1981, p. 10.

> . . . Chicago school economics, supply-side economics, call it what you will—I noticed that it was even known as Reaganomics at one point, until it started working—all of it is fast becoming orthodoxy. It's not just that Milton Friedman or Friedrich von Hayek or George Stigler have won Nobel Prizes; other younger names, unheard of a few years ago, are now also celebrated.[2]

Reaganomics continued to be highly influential long after Reagan left office, and a quarter century is not too soon it assess its record. My scorecard shows two wins, one draw, and two defeats—and several lessons for the future.

Money. The first win was monetary policy. In the late 1970s a decades-old academic debate still raged between a still-dominant liberal camp and an insurgent conservative camp. Liberal economists such as James Tobin and Robert Solow argued that monetary policy should aim primarily to achieve low unemployment; this, they said, would inevitably generate some price inflation, and we would just have to learn to live with inflation as the price of strong employment. Conservative economists such as Milton Friedman and Allan Meltzer argued that monetary policy should aim single-mindedly for price stability; this, they said, would provide the necessary framework for efficient investment and productivity growth, and thereby promote high levels of employment.

That debate has been over for a long time: the Friedmanites won a brilliant victory during the Reagan years that has proven highly durable. In the twenty-four years since the inflation-breaking year of 1982, during which the Federal Reserve Board has pursued a consistent low-inflation policy, inflation averaged less than 2.6 percent—as compared to 7.6 percent for the decade before 1982. For the same periods, unemployment fell from an average 7.0 percent to less than 6.0 percent, and has continued to fall. Reagan's famous "misery index"—the sum of the inflation and unemployment rates—which had climbed above 20 during the election year of 1980, has averaged 8.5 since 1982 and fell nearly to 6 in the late 1990s. Today no one is arguing that inflation is something we should tolerate in order to achieve low employment or other economic goals. When Ben Bernanke was nominated to be Fed chairman in the fall of 2005, the low-key confirmation debates focused on subsidiary issues such as whether the Fed should publicly announce its inflation targets.

[2] White House Briefing for Members of the Deficit Reduction Coalition, July 10, 1987.

It is important to recognize, however, that the triumph of low-inflation monetary policy was also a result of practical experience and a convergence of liberal and conservative understanding that began before 1981. The crisis of the old monetary order began with the stagflation of the 1970s, presided over by Federal Reserve Board Chairman Arthur Burns, a conservative Republican. Burns was a stable-money man but accepted the notion of a trade-off between inflation and unemployment and believed that unemployment as high as 7 percent was politically unacceptable. He tried to hold money growth in check but eased up whenever unemployment began to inch up—a monetary lurching that kept financial markets on pins-and-needles and produced a disastrous inflationary spiral. And it was a liberal Democrat, Fed Chairman Paul Volcker, who turned the corner: his relentless, Joubert-like crusade against inflation yielded unemployment rates far higher than Burns had thought acceptable, persisting for years before stable low inflation became the new norm and unemployment began to fall.

Ronald Reagan deserves great credit for standing unflinchingly by Volcker in this politically perilous passage. But so does Jimmy Carter, who appointed Volcker knowing his intentions and virtually never criticized him thereafter, even when Carter's advisers warned that the messy early phase of the Volcker crusade could cost him the 1980 election.

Deregulation. The second big win was regulatory and antitrust policy. Deregulation, like stable money, began as a staple of conservative economics and was a central tenant of Reaganomics. Reagan's first, flamboyant act as President was to abolish federal price controls on oil and gasoline—a step that the media and many Democrats predicted would lead to soaring prices, but that instead lowered them exactly as Reagan predicted. He also presided over the decontrol of natural gas prices and the abolition of the Civil Aeronautics Board, signed legislation putting the Interstate Commerce Commission on track to extinction, and never missed an opportunity to highlight and ridicule the perverse effects of government rules. His policy toward environmental and safety regulation was to require that individual rules pass a cost-benefit test showing that their social benefits were worth their economic costs.

Both economic deregulation and economics-based reform of social regulation proved to be durable contributions. Washington had no appetite for old-fashioned price-and-entry controls in the post-Reagan years, and remained largely passive in the face of disruptive industrial restructurings that would have prompted a binge of protectionist regulation in earlier eras. Reagan's successors all continued to require that the Environmental Protection Agency, the Occupational Safety and Health Administration, and the National Highway Traffic Safety Administration submit their rule-making proposals for cost-benefit review. Deregulation of telecommunications has proceeded fitfully, pharmaceutical price controls continue to threaten, and new forms of regulation such as the Sarbanes-Oxley Act have sprung up—but these continuing battles do not diminish the dramatic progress that has been made.

As in the case of monetary policy, one is struck by the growth of intellectual consensus—beginning before the Reagan years and including both academics and politicians—around what had previously been conservative positions. A thoroughgoing critique government regulation emerged in the early 1970s, finding its Washington home not only at the American Enterprise Institute but the Brookings Institution, whose economists collaborated closely on regulatory issues (as they do to this day). Gerald Ford was a forceful deregulation advocate during his brief term, but Jimmy Carter was equally forceful and more successful. Carter appointed Alfred Kahn, an economics professor and outspoken deregulator, to chair (and disable) the Civil Aeronautics Board, and signed the Airline Deregulation Act of 1978—itself the handiwork of Senator Edward Kennedy and his aide Stephen Breyer, a liberal law professor who would eventually be appointed to the Supreme Court by Bill Clinton. Reagan's program of economics-based oversight of the health, safety, and environmental agencies was based on antecedents going back to the Nixon Administration, and employed a regulatory-review requirement enacted by a Democratic Congress and signed by Jimmy Carter in 1980. Today, when political leaders of either party succumb to populist pressures (as in the recent bi-partisan calls for price controls or "windfall profits" taxes on gasoline suppliers), they are sternly rebuked by economic advisers in their own parties. And when agencies such as the EPA propose nice-sounding but harmful rules they are debunked by nonpartisan groups such as the AEI-Brookings Joint Center for Regulatory Studies.

Most impressive of all was the revolution in antitrust policy. In the early 1970s, Chicago economist Aaron Director and legal scholars Robert Bork and Richard Posner mounted a root-and-branch critique of then-prevailing antitrust doctrines that tightly restricted mergers, price competition, and product distribution. Antitrust, they said, should be guided by the criterion of consumer welfare, not by ad hoc balancing the interests of rival producers. At first their views were regarded as radical, even a bit crackpot, but they gained ground steadily in the 1970s, working their way from classrooms and law journals to law clerks and judges. With Reagan's inauguration they became official policy at the Justice Department's antitrust division (headed by law professor William Baxter) and the Federal Trade Commission (headed by economics professor James C. Miller III).

The triumph of conservative antitrust policy was a tour de raison—in contrast to that of conservative monetary policy, it was not prompted by external shocks or policy crises that unsettle conventional wisdom and forced a change from the status quo. It was so thorough that by the end of the Reagan Administration the Justice Department and FTC were *losing* cases in court. The pattern of economics-driven enforcement policies, and even more economics-driven judicial decisions, continued essentially unchanged thereafter. The economic benefits have probably been as great as those of price stability: much of the industrial restructuring of the past twenty years, and many of the pricing and product-distribution practices that have emerged in the new information economy, would have been unlawful under pre-1980s antitrust. As in regulatory policy, there is much for conservative economists to quarrel with in present-day antitrust (especially merger) enforcement. But today's antitrust debates, grounded on all sides in considerations of economic efficiency and consumer welfare, are worlds apart from pre-1980s mish-mash of populism and armchair industrial planning.

Taxes. Tax policy has absorbed more conservative political energy than any other economic issue in the past twenty-five years, but the results must be judged a draw. The achievements have been substantial. Reagan won steep reductions in marginal income tax rates that proved durable through several subsequent tax revisions authored by both Democrats and Republicans; the reductions have affected not only the highest earners, whose top statutory rate was 70 percent in 1980 and is 35 percent today, but essentially all taxpayers across the income spectrum (for example, couples with income of $45,000–55,000 in 2005 dollars paid a top statutory rate of 28 percent in 1980 but pay only 15 percent today). The initial arguments of liberal critics that sharp tax reductions would generate a wave of price inflation proved unfounded and have disappeared from policy argument. And Reagan, in league with Dan Rostenkowski and other House Democrats, forged the Tax Reform Act of 1986, which made the tax code simpler and more efficient by broadening the tax base in exchange for reduced tax rates and the eliminations of various loopholes.

But these achievements have been offset by several adverse developments. Tax policy, in contrast to monetary, regulatory, and antitrust policy, has remained highly partisan among practicing politicians. Successive rounds of legislation, reflecting shifting balances of power between Republicans and Democrats, have left the tax code with many anomalies that have entrenched both sides and made sustained reform progressively more difficult. One anomaly is the result of the introduction or expansion of tax deductions and credits for child care, education, and retirement saving, and many other things, combined with the Clinton-era innovation (a grubby substitute for raising tax rates forthrightly) of phasing out deductions and credits as income increases. This has produced a pattern of effective marginal tax rates that economist Kevin Hassett has dubbed the "skyline tax." Consider a representative family of four that takes the available deductions and credits which phase in and out at different income levels. At an income of $25,000, the family faces a marginal tax rate of 21 percent, but at an income of $50,000 the rate falls to 0 percent; at $100,000 the marginal rate soars to 46 percent, and then at $145,000 it falls back to 28 percent. Tax rates that rise and fall willy-nilly reflect no one's idea of tax equity or efficiency. They reflect, rather, the terms of ceasefire in the last several legislative battles.

Another anomaly has arisen from the one thing conservative and liberal politicians have been able to agree on since Reagan: that it is desirable to exclude increasing numbers of lower-income people from the income tax rolls altogether. This they have done by raising tax brackets and expanding targeted credits and deductions, especially the Earned Income Tax Credit. The number of Americans who file a federal income tax return but owe no tax has risen from about 19 percent when Ronald Reagan left office to about 32 percent today. According to the President's Advisory Panel on Federal Tax Reform, *all* income tax revenues in 2006—100 percent—will come from 50 percent of taxpayers (a term that includes households, not just individuals). The upshot is that a very large proportion of the adult American population, probably close to 50 percent, now pays no direct support at all for the general operations of the federal government, from national defense to medical research, highway construction to farm subsidies. This cannot be good for the political health of a nation that is widely prosperous, highly democratic, and deeply attached to principles of fairness and equality. And it has seriously complicated the task of tax reform. Every proposal to reform the income tax code that does not involve a tax hike, no matter how sensible in economic terms, is now immediately attacked as a giveaway to the rich. The charge is accurate—because only the rich (very broadly defined) now pay any income taxes at all.

There is a lot of blame to go around for the current paralysis in tax policy, and conservatives are naturally inclined to blame liberal tax-grabbers and soak-the-richers. But a good part of it has resulted from the profusion of theories, analyses, and strategies among conservatives. Since Reagan the conservative tax reform movement has had three main flanks, and they have spent as much time shooting at each other as at the Democratic tax grabbers and soak-the-richers across the field. Tax rationalizers want to make taxation more economically efficient by reducing tax rates, especially on investment income, in conjunction with broadening the base, eliminating deductions and exemptions, and other changes to make private decisions less driven by tax considerations. Tax cutters want to reduce taxes pure and simple, at every political opportunity and no matter what else happens.[3] And social conservatives want to use the tax code to promote family formation and childbearing; they favor all of the family-friendly credits and deductions that crowd out across-the-board rate reductions that improve economic efficiency and growth.

The conservative cacophony has left the field open to partisan redistributive politics that has worked especially to the disadvantage of the conservative tax rationalizers. They were burned by the bipartisan compromise of 1986, which followed their prescription of base broadening and rate reducing—the broadened base set up the Democrats to raise rates and introduce new constituency favors when they got back to power 1990s, just as the conservative tax cutters had predicted. This explains why the Bush administration immediately abandoned the excellent tax-rationalization proposals of its own Federal Tax Reform panel when they were released in the fall of 2005. The

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[3] Conservative tax cutters in turn march under three distinct banners. *Supply-side tax cutters* argue that reducing marginal rates will often increase tax revenues because of the positive effects on private incentives for work and production, and that even where revenues fall it is always by less than predicted by the government's tax "scoring" authorities and often compensated by gains in private economic growth. *Starve-the-Beast tax cutters* proceed from the opposite assumption: they argue that tax cuts will reduce government revenue and thereby generate political pressure for curbing government spending, which is difficult to do my direct means. *Realpolitik tax cutters* simply want Republicans to win rather than lose elections: adamant Republican commitment to tax reduction is to be the means of outflanking adamant Democratic commitment to government spending programs at the polls.

Democrats said they were game to negotiate a new tax bill based on the panel's recommendations—but only if they were not required to commit in advance to making permanent the temporary Bush tax cuts passed in 2001 and 2003. To the tax rationalizers it looked like an acceptable risk, but to the tax cutters it looked another trap.

There is an important lesson in our pattern of two wins and one draw. Economists and lawyers who are politically active conservatives (or for that matter politically active liberals) have a dual loyalty problem. They belong to strong professions with their own norms, traditions, and standards of evidence and their own forms of promotion, recognition, and prestige. There are conservative economists who would raise taxes, just as there are liberal lawyers who would overturn *Roe v. Wade*. For these reasons, relations between conservative economists and lawyers and their less compromised political brethren—in the heat of battle on the campaign trail or at the White House or Treasury Department—can sometimes be difficult.

But the histories I have sketched show that that tensions can be highly productive. When you achieve a degree of professional consensus, as we have in monetary, regulatory, and antitrust policy, you provide prestige and momentum to a set of ideas that will affect the views of practicing politicians on both sides of the aisle about what is permissible and desirable in policy debate and about what tools to grasp in a crisis. Last year AEI published a volume of essays on tax reform, edited by Kevin Hassett, who has been know to consort with Republican office holders and office seekers, and Alan Auerbach of Berkeley, who probably would have been chairman of President John Kerry's Council of Academic Advisers. The authors were a politically diverse group of the nation's top tax experts, and it is possible to discern in their essays a liberal-conservative convergence on fundamental reform: tax consumption not income, stop taxing investment income in particular which has become a fool's errand, and let political representatives fight it out over the degree of progressivity in a consumption-based system.

Now for my two losses.

Spending. The first is spending restraint. In the 25 years since Ronald Reagan came to town declaring his intention to curb the growth of government, domestic spending has more than doubled in real terms. Spending growth has been particularly pronounced during the years of unified Republican government since 2001, and not just for earmarks and Jack Abramoff's Indian tribes but for a near doubling of education spending and for a huge unfunded new middle-class entitlement for prescription drugs. In power, Republicans turn out to be just as enthusiastic spenders as Democrats, and just as avid pursuers of Allan Meltzer's median voter. They have even cooked up a theory, called "big government conservatism," to justify the transition.

There is an important asymmetry between the two economic and political camps on the spending question. Liberal economists and liberal politicians are at one: both tend to think that when money is taken out of the private economy and spent by the government, whether for small business subsidies or Medicaid or whatever, the result will generally be to improve social welfare. Conservative economists are very dubious about that proposition, but we are now at odds with our politician compatriots, and without any prospect of achieving a professional consensus among our economist peers.

It may be a mistake to regard aggregate spending as an economic policy issue at all—a vestige of the pre-Reagan days when economists took seriously the idea of "fiscal policy," in which taxing and spending would be calibrated to optimize private economic performance at different phases of the business cycle. Since Reagan, all of the devices that have been employed to attempt to discipline government spending have been political or procedural expedients: the Starve-the-Beast strategy, a variety of congressional budget-process procedures, and the line-item veto. None of these expedients seem to have had much effect; the budget procedures give an upper hand to different institutional forces within the Congress, and the line-item veto gives an upper had to the President over the Congress, but the result is to change the composition of spending rather than its level.

Vouchers. The second failure has been voucherization and privatization—the idea that many public programs, such as schooling, Social Security, Medicare, and a long list of social welfare services, would be much improved if the government relinquished its one-size-fits-all monopolies by providing vouchers to individuals to purchase the services as consumers from private or government suppliers.

This failure of these proposals, which conservative economists have been promoting since the 1960s, is something of a puzzlement. The programs are voluntary—the Bush social security proposal would permit anyone to stick with the current Social Security program instead of buying into personal accounts, and parents with vouchers could use them to stay in public schools. And they are promoted in the name of individual choice, an idea with broad appeal in American culture across the political spectrum. I think there are three reasons why they have failed to catch on.

First, all of the public programs in question have embedded within them a large number of hidden cross-subsidies, including many to the middle class. Vouchers can be targeted on the poor and made as progressive as you please, but the effect is to expose or unravel the middle-class subsidies that are for various reasons important to the Democratic Party. In their party caucuses, Democrats worry that making Social Security and Medicare highly progressive would erode political support for the programs among the middle class. At an AEI lecture several years ago, Harvard economist Caroline Hoxby showed that it is possible to design a school voucher program that incorporates the subsidies for handicapped students, minority students, and others that are currently part of the financial structure of public schools; it was a complex and politically unappealing scheme, and a roadmap to the interest groups that would fight to keep the subsidies implicit rather than explicit. By far the largest subsidy in public education is to the teachers unions whose members provide teaching services as a near monopoly, a status that would be lost in a truly competitive school choice program. Many good liberal policy experts favor school choice and other voucher proposals; their politician friends listen to them about as much conservative politicians listen to conservative economists about spending control.

Second, many of the school voucher programs that have been tried around the country provide, as Rick Hess has shown, only weak forms of choice where, when parents move their child out of a school, the school suffers no financial loss and may even gain average revenue. The result is that much of the evidence of the effects of school choice has been weak or equivocal compared to the real potential of vouchers, especially on the question of public school performance of uppermost concern to many parents. When parents are able to deny resources to one school and give it to another school, the public schools will begin to improve instantly.

Third, many people seem to be uneasy about applying the idea of personal choice to public goods such as education, retirement pensions, and welfare services that they regard as part of the legitimate fabric of government. Until the libertarian revolution arrives, conservative activists should pay more attention to the economists in their midst, for whom choice is not only a good in itself but also the force that drives competition in supply, leading to lower price and higher quality. Supply-side arguments would emphasize the large public improvements that vouchers would bring to schools, retirement investment programs, health care, and other important services—for all individuals and for society as a whole, not just for the individual considered apart from the society he belongs to.

Standing at the intersection of our two greatest policy failures, spending control and voucherization, are our two mammoth health care programs, Medicare and Medicaid, growing like Topsy. Health care it is unique in featuring a sharp ideological divide that is highly symmetrical between conservative economists and politicians on the one hand and liberal economists and politicians on the other. Both breeds of conservative favor reforms to greatly reduce government regulation and financing of medical care, leaving the sector to be governed largely by competitive private markets with a social safety net. Liberal politicians, and liberal economists who devote themselves to health care policy, are for the most part in favor of outright health care socialism in the form of what is euphemistically called a single-payer system. Each camp fashions its every incremental proposal with a view towards its larger goal. Whether conservative economics is as successful in the next twenty-five years as it has been in the last twenty-five years will depend to largely on how this battle, so far unmediated by the emergence of any professional consensus, turns out.

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