

Chapter 6

Reaganomics and its Legacy

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In his memoirs, Ronald Reagan underlined the primary significance of economic policy to his presidential agenda. As he put it, “Nothing was possible unless we made the economy sound again.”¹ From the late 1960s to the early 1980s the United States had experienced its worst economic problems since the 1930s. The development of stagflation—concurrent inflation and stagnation—had produced three recessions and unprecedented price instability. Matters appeared to reach crisis point by late 1980. Productivity growth had ground to a virtual halt and the misery index—the combined rate of inflation (13 percent) and unemployment (7 percent)—stood at 20 percent. In the quarter-century since 1983, by contrast, the American economy has been a vibrant engine of almost continuous growth, high employment, and low inflation. In this period there have only been two shallow recessions (at time of writing), an average of one every twelve years. Never before has the United States enjoyed a period of such prolonged expansion and little contraction. Between 1949 (the date of the first postwar recession) and 1980 the average duration of each expansion cycle was barely 4.5 years. During the era of what some economists call “the great expansion,” the United States consolidated its position as the number one economic power in the world, a status it had looked to be in danger of losing by the end of the 1970s.

Ronald Reagan promised the most dramatic changes in economic policy since the New Deal to tackle the worst economic crisis since the Great Depression. He blamed America’s woes on postwar liberal statism that burdened the economy with high taxes to support big spending government. As president he looked to develop a market-oriented political economy that freed the productive potential of individuals from the dead hand of government.² Unsurprisingly conservatives have attributed the great expansion to the ongoing influence and legacy of Reaganomics. In 2000, conservative economist and former Federal Reserve governor Lawrence Lindsey declared that the years since 1983 were best seen “as a single expansion, with its roots in the policy changes of the late 1970s and early 1980s.”³ In 2004, Stephen

Moore, president of the Club for Growth—a Washington-based group that lobbies for lower taxes—declared that George W. Bush had completed the transformation of the GOP into a supply-side party. “It has evolved over the past forty years,” he avowed, “from being a party of Eisenhower balanced-budget Republicans into a party of Reaganite pro-growth advocates.”⁴

The record of the economy since the early 1980s did not fulfill the gloomy foreboding of Reagan-era liberals that their nemesis was destroying its well-being. Typifying their disdain, Keynesian doyen James Tobin of Yale, one of the founding fathers of the 1960s “new economics” as a member of the Kennedy CEA, charged that Reaganomics was “a fraud from the beginning.” In his view it simply proved that “a nation pays a heavy price when it entrusts its government and economy to simplistic ideologues.”⁵

In a not uncritical study of Reagan and his era, historian Robert Collins offers a more balanced and persuasive assessment. Reagan’s achievements, he suggests, should be counted in terms of the alternatives he forestalled. Without his free-market approach, the U.S. response to stagflation and an increasingly competitive international economy would have probably moved in the direction of statist programs of industrial policy and strategic trade exemplified by the then successful model of Japan’s Ministry of International Trade and Industry. However, the subsequent stagnation of the Japanese economy revealed the limitations of a political economy that gave government greater responsibility than the market for resource allocation. At the same time Collins warns against attributing too much influence to Reagan for the economic success that continued long after he left office because policies and circumstances changed significantly.⁶

It is worth recalling that the New Deal hardly had a stellar economic record but its significance in launching the Keynesian political economy of the postwar era is not in dispute. With this in mind, this essay assesses Reaganomics as a mixture of success and failure in terms of its management of the economy and offers a brief evaluation of its legacy for the post-Reagan era. It focuses on three issues: the fiscal–monetary mix in economic management; the significance of Reagan’s tax program; and America’s transformation in the 1980s from being the world’s largest creditor nation to being its largest debtor nation.

The Monetary–Fiscal Mix of Reaganomics

The new political economy that emerged in the 1980s was different in critical respects from Reagan’s blueprint. This was most evident in its operation of massive budget deficits instead of the balanced budgets originally promised. To his critics, Reagan replaced a “tax-and-spend” economic policy with a “spend-and-borrow” one. Equally significant was the development of a monetary–fiscal mix of demand management to promote economic growth in place of the supply-side strategy initially heralded as the means to this end.

The original manifesto of Reagan’s economic ideas was *Economic Policy Memorandum Number 1*, drawn up in 1979 by aide Martin Anderson in

readiness for the presidential campaign. The *Program for Economic Recovery* [PER] that the new president sent to Congress in February 1980 embodied its principles. As enunciated in these two statements, Reaganomics had a fiscal core of tax reduction and domestic spending restraint. Its emphasis on tax cuts as the agency of economic growth reflected new supply-side economic ideas that high marginal tax rates weakened the incentive of individuals to work, save, and invest. Its commitment to balance the budget by the end of Reagan's first presidential term reflected conventional conservative belief that big government spending was a drag on the economy. The role of monetary policy in this schema was a supporting one of keeping inflation under control through moderate restraint while fiscal measures worked their magic to revitalize productivity growth as the ultimate guarantor of price stability.⁷

However Federal Reserve chairman Paul Volcker was reading from a different script that cast him as commander-in-chief in an all-out war on inflation. His appointment in the summer of 1979 was an act of desperation by Jimmy Carter in the face of double-digit inflation. Volcker had won the confidence of Wall Street as an inflation hawk in his former post as head of the regional New York Federal Reserve. Hitherto postwar Democratic and Republican administrations had largely prioritized fiscal policy in managing the economy in accordance with the Keynesian formula for growth and high employment. With the emphasis changed to fighting inflation through monetary policy in the late 1970s, the Fed chair became the chief manager of prosperity, a role that the Employment Act of 1946 had implicitly conferred on the president. The political economy of the 1980s only served to confirm his status in this regard.

Volcker considered the central bank complicit in fueling inflation through its easy money policies in the 1970s. He drew three lessons from this era. First, policymakers' pursuit of a "Phillips curve" trade-off that targeted appropriate rates of employment growth for inflation growth had only made things worse. Second, the conquest of inflation at whatever temporary cost to unemployment was the precondition for economic revival. Finally, inflation-wary lenders would not commit sufficient investment funds to promote economic growth unless the Federal Reserve had credibility as an inflation-fighter.⁸

Under Volcker, the Fed immediately pursued a money-targeting strategy to control the money supply that helped push the economy into a brief but sharp recession in mid-1980. Despite temporary relaxation to assist recovery, the consequence of Fed policies in the form of higher borrowing costs and rising unemployment proved unhelpful to Jimmy Carter's hopes of reelection. Volcker did not change course with a new president in the White House. In the second quarter of 1981 the Fed stepped up the restrictive strategy that it had pursued almost continuously since late 1979 in a bid to wring inflation out of the economy once and for all. This precipitated the worst recession since the 1930s. The downturn began in August 1981 and lasted through 1982. At the trough, unemployment stood at 10.8 percent of the workforce, compared with the average of 7.1 percent at the same stage of previous postwar

recessions, and factory utilization was only 68 percent of capacity, the lowest since records were first compiled in 1948. Although recovery began in early 1983, unemployment rose to a peak of 11.5 million in January.⁹

The recession had grave consequences for the fiscal calculations of Reaganomics. It destroyed the harvest of new revenues that economic growth was supposed to deliver with the tax-cut fertilizer. By FY1985 federal receipts had only recovered to 86 percent of the level projected by PER. By undermining Reagan's popularity, the downturn also helped stiffen the resolve of the Democrat-controlled House of Representatives to resist further domestic retrenchment to help pay for the other elements of his fiscal program. Reagan's blitzkrieg of tax cuts, defense expansion, and a first installment of domestic retrenchment had stormed the legislature during his first year in office but budgetary politics became bogged down in the stalemate of trench warfare for the remainder of his presidency. This combination of circumstances drove the deficit into the stratosphere with the consequence that the national debt held by the public rose from \$711.9 billion at the end of 1980 to \$2.1 trillion eight years later.¹⁰

The huge deficits threatened to derail Reagan's promises of economic growth because financial markets conventionally regarded them as harbingers of inflation. Reagan adviser Alan Greenspan warned that the Fed would likely keep its foot on the monetary brakes to assuage market psychology as long as federal finances continued to hemorrhage red ink. Contrary to expectations, Volcker relaxed monetary policy in July 1982 shortly before enactment of the Tax Equity and Fiscal Responsibility Act (TEFRA) that purported to raise \$98 billion over three years mainly through closure of tax loopholes. There was no clear evidence that Reagan's deficit-control concession on new taxes had brought about the Fed's change of course, but the president was convinced that it had. Further monetary relaxation over the next three months allowed the M1 money supply (currency in circulation and checking accounts) to grow by 15 percent, which did much to generate economic recovery in early 1983.¹¹

Projections that the deficit would remain around \$200 billion for years to come made the president nervous that Volcker might once again rain on his parade. A distraught Reagan reportedly exclaimed to the Budget Review Board on January 3, 1983, "How can we come out with that string of figures without driving interest rates right back up?"¹² However, the Fed stayed its hand because inflation did not revive in the face of the huge deficits. Double-digit inflation had vanished in the recession. The consumer price index rose by a yearly average of only 3.5 percent during the remainder of Reagan's presidency. Accordingly, monetary aggregates grew on average quite rapidly from mid-1982 to early 1987 at a rate that would have been deemed inflationary in the late 1970s. Only when mild inflationary pressures resurfaced in 1987–1988 did the Fed engage in a modest tightening of monetary policy.¹³

The monetary castor oil of 1979–1982 had purged massive inflation from the economy. A combination of other factors worked against its renewal.

American manufacturers grew leaner and more efficient but at a cost to jobs in the context of an increasingly competitive international economy. Manufacturing productivity rose by 4.1 percent from 1980 through 1987, well above the postwar norm, which allowed for the maintenance of production levels with fewer workers. By the end of 1987, only 19.3 million Americans worked in manufacturing compared with 21 million in 1979. A global oil glut in the mid-1980s ensured no repeat of the supply shocks that had been a major source of inflation in the previous decade. Finally, the unprecedented numbers of women and baby-boomers that had entered the labor force in the 1970s became more productive with greater experience.¹⁴

The conquest of inflation, which had troubled the American economy for more than a decade, was the greatest economic policy success of the 1980s. The institutional actor primarily responsible for this was the Federal Reserve under Paul Volcker's leadership. In the latter's estimate, Reagan's most important contribution to the battle was defeating the air traffic controllers' strike in 1981 because this helped temper labor militancy and preempt a new round of inflationary wage increases. He also appreciated that Reagan's steadfast public support shielded him against the open criticism of many politicians from both parties in Congress, even though administration officials lobbied him behind the scenes in the spring and summer of 1982 for monetary relaxation.¹⁵

The tight money policy that had blown the Reagan administration's optimistic economic projections off course ultimately proved the salvation of its tax program. Once reassured that \$200 billion deficits were not going to drive up interest rates again, the president could dig in his heels against any retreat on personal income tax reductions for the sake of deficit control.¹⁶ In the 1984 presidential election, Democratic candidate Walter Mondale ran on a platform calling for deficit-reducing tax increases to avert another economic catastrophe like that of 1981–1982. With the recovery now gaining momentum, Reagan was able to turn the contest into a referendum on his tax program. He defined the election as a choice between growth based on the fundamental values of individual freedom represented by his personal income tax cuts and stagnation resulting from Mondale's statist agenda of tax increases.¹⁷

The renewal of economic growth hardly represented the triumph of supply-side economics. The management of prosperity in the Reagan era relied on a flexible monetary policy that varied between being very tight and relatively relaxed and an expansionary fiscal policy, a combination that operated through the demand side of the economy. This proved far from a perfect mix, however. As discussed later in this chapter, the expansionary budget deficits contributed to a collapse in national saving. Compensating for this, even though the Federal Reserve relaxed monetary policy from mid-1982 onward, it kept real interest rates (the actual interest rate minus the rate of inflation) above their postwar norm to attract investment in the United States by foreign savers. The consequences were a strong dollar and a growing trade deficit that produced a slower decline in unemployment than in

previous recovery cycles. Joblessness did not fall below the 1980 recession-year level of 7 percent until 1986.

In the opinion of conservative economist Herbert Stein, the 1980s demonstrated two realities for economic policymakers. First, the supply-side approach provided neither explanation nor solution for inflation. Second, the power of government to influence the supply-side of the economy was much smaller than its capacity to manage demand.¹⁸ The Fed's conquest of inflation was proof of the former. The limited benefits of the Reagan tax program for productivity growth of output per employee was proof of the latter. The strong gains in manufacturing productivity were the exception rather than the rule in the 1980s. Total non-farm productivity growth averaged only 1.3 percent annually under Reagan compared with 2.8 percent between 1945 and 1973. Economic growth, which averaged 4.1 percent from 1983 through 1988, was largely due to aggregate demand catching up with potential GNP after a serious recession. Whatever else it achieved, Reaganomics did little to boost capital formation, the prerequisite for productivity improvement. Private investment in 1980–1992 was only 17.4 percent of GDP compared with 18.6 percent in the economically troubled 1970s.¹⁹

The Reagan Tax Program

Tax reduction was the defining element of Reaganomics but its economic significance was more ambiguous than its political importance. Reagan's tax cuts gave the Republicans the banner issue that was fundamental to their electoral success in the late twentieth century and beyond. As it eventually developed, however, his tax program was a manifestation of his populist conservatism rather than of supply-side economics.

Enactment of the Economic Recovery Tax Act (ERTA) of 1981, the largest tax reduction in U.S. history, was Reagan's greatest success in his first year as president. This cut the top individual income tax rate from 70 percent to 50 percent on January 1, 1982, and reduced rates for all other taxpayers in three annual stages of 5, 10, and 10 percent (aggregate reduction 23 percent). Congressional add-ons significantly expanded the measure beyond the terms of the administration's original bill. In particular, the automatic indexation of personal income tax to inflation from FY1985 onward eliminated the "bracket creep" phenomenon that had enlarged individual tax burdens and federal receipts in the 1970s. In addition ERTA was turned into a Christmas tree of deductions and benefits to business, including faster write-offs for capital expenditures, an increase in the investment tax credit, and benefits for oil producers.

Reagan consistently supported the ERTA personal tax cuts for the remainder of his presidency even as he made concessions on other forms of taxation. In his eyes, high personal taxes threatened the liberty of American citizens by confiscating the wealth they created to feed a rapacious big government.²⁰ The president's priorities were at variance with those of first-term Office of

Management and Budget director David Stockman. Originally a true believer in Reaganomics and in many respects the engineer charged with turning its blueprint into reality, Stockman quickly lost faith when the consequences for the deficit became apparent in the second half of 1981. In late September the budget director vainly advocated a one-year deferment of the second and third installments of the ERTA personal tax cuts to mitigate deficit growth. In unguarded remarks to journalist William Greider, he described the across-the-board income tax cuts as a "Trojan horse." From his perspective, their sole purpose was to provide a political smokescreen for ERTA's tax breaks for business and the immediate cut in the top rate of personal income tax that would be the real drivers of economic expansion because of their benefits for investment. Stockman's influence in the White House went into decline following publication of these comments.²¹ He had failed to understand that his boss regarded across-the-board personal tax reduction as the core of his economic program rather than the trimmings.

Far from accepting that ERTA had inflated the deficit, Reagan clung to the belief that the economic growth it generated would produce a compensatory revenue reflow.²² This conviction was based on the theory of supply-sider Arthur Laffer that there was a point on the tax rate curve between 0 and 100 percent beyond which higher taxes yielded fewer revenues than a lower tax rate. The "Laffer curve" never plotted the point at which the change occurred, acknowledged that a higher tax rate would still yield more revenue than a lower rate below this apex, and did not claim that tax cuts would pay for themselves.²³ However, Reagan's simplistic distortion of this theory reinforced his conviction that income tax cuts generated additional revenue for government and income tax increases had the opposite effect.²⁴

The experience of the 1980s offered conclusive proof that the reverse was true. Allowing for the effects of recession, ERTA cost \$643 billion in revenue in its first five years of operation. In contrast, corporate income tax increases levied by TEFRA and the Deficit Reduction Act of 1984, a smaller loophole closing measure enacted to blunt deficit concerns in an election year, benefited federal coffers. In combination with the social security tax increases of 1983, these measures offset the revenue loss from ERTA by about a third.²⁵

If Reagan's misappropriation of the Laffer curve theory fortified his belief in tax reduction, it is difficult to find other consistent threads of supply-side principle in his administration's tax program. The president's 1982 *Economic Report* promised that the ERTA incentives would significantly encourage new investment.²⁶ Belying this, TEFRA eliminated a number of the business tax breaks that Congress had appended to the 1981 tax cut. Supply-siders regarded the change of course as a self-defeating betrayal of their faith on Reagan's part. In their eyes, TEFRA crowded productive dollars out of the economy at a time of recession, thereby hindering economic expansion that was the most effective instrument of deficit reduction. To the relief of pragmatic White House aides such as chief of staff James Baker, a number of supply-siders—notably Treasury officials Paul Craig Roberts and Norman

Ture—quit the administration in 1982 as Reagan moved toward approving the tax increase.²⁷

Worse was to follow from the supply-siders' perspective as Reagan turned into a tax reformer in his second term.²⁸ The original inspiration for this was to counter anticipated Democratic charges in the 1984 election that his tax program was biased to the rich. Donald Regan and James Baker, who exchanged their first term posts as Treasury secretary and chief of staff, promoted development of what became the Tax Reform Act of 1986. This simplified the fourteen-bracket tax code into two of 15 percent and 28 percent (with a complicated surtax that put some upper middle class families in a "bubble" bracket of 33 percent). An estimated 80 percent of American taxpayers came within the 15 percent bracket. Meanwhile the top tax bracket, which had been 70 percent in 1981, was now lower than the bottom marginal tax rate in some Western European countries. Thanks to enhanced exemptions for taxpayers with dependents, TRA also removed six million poor Americans from the tax rolls. At the same time it eliminated or reduced deductions and other benefits that favored high-income taxpayers. Accordingly, the measure produced lower taxes for about 60 percent of taxpayers, higher ones for 15 percent—mainly the wealthy, and left them the same for 25 percent.²⁹

To ensure that this largess did not inflate the deficit, TRA paid for its personal tax cuts by shifting a tax burden of \$120 billion from individuals to corporations in its first five years of life. Even though it cut the basic rate of corporate taxes, it significantly broadened the corporate tax base through elimination of the investment tax credit, much slower depreciation allowances, and a stiff alternative minimum tax for corporations. ERTA's strategy of creating tax expenditures to encourage saving and investment was reversed by the TRA's elimination of seventy-two of these benefits for business and individuals in the cause of tax fairness. According to one estimate, TRA raised the effective tax rate on new business investment in equipment of all kinds by some 20 percent. No dispensation was made for research and scientific equipment, so the measure arguably had adverse consequences for America's efforts to compete in new technology and related industries.³⁰

If Reagan's tax program did not live up to supply-siders' hopes of boosting investment, some analysts still considered it instrumental in improving living standards for many Americans in the 1980s. Historian John Diggins argued that impressions of the Reagan era as "a time when the rich exploited the poor must be revised if history is to be faithful to statistics." In the two years after TRA's enactment, the top 5 percent of taxpayers paid 45.5 percent of all personal income taxes compared to 41.8 percent in 1986, while the bottom 50 percent of taxpayers moved in the opposite direction from 6.6 percent to 5.7 percent. Income distribution data also suggested that the economic recovery that ERTA helped to generate was a rising tide that lifted all boats not just the yachts of the wealthy. By 1986, the bottom income quintile accounted for 28 percent of the total personal income gain since 1977 compared with 11 percent for the top quintile.³¹

Whether lower income groups did become significantly better off in the 1980s is open to question. The regressive social security tax increases enacted in 1983 to safeguard program trust fund solvency canceled out the benefit of the Reagan income tax cuts for many Americans in the bottom half of the income distribution. Moreover the standard of living of single-income families stagnated in the 1980s. In 1983 the average U.S. worker earned \$281 per week, but only \$271 as measured in 1983 dollars by the end of 1989. In the Reagan era, most families in the lower half of the income distribution only increased their income by having two adult earners rather than one. By 1987, 49 percent of all married couples were working couples. Even two-income families found that higher costs for housing, health care, and education offset a goodly portion of their growing income.³²

If the debate on the distributional benefits of Reaganomics remains unresolved, what is not in doubt is that there was no investment revolution in the 1980s. Net business capital formation annually averaged 3.5 percent of total income during the 1960s and 3.3 percent in the 1970s but only 2.3 percent from 1981 through 1987. Between 1980 and 1987 the rate at which the capital intensity of America's production rose declined by half. In contrast the demand side of the economy underwent some expansion in the Reagan era. Per capita consumer spending rose 2.2 percent a year in this period, comparable with the pre-1973 level but well above that of 1.4 percent for 1973–1980.³³

As noted earlier, the growth of two-income families offers some explanation for the expansion of consumer spending. Additionally, Reagan fiscal policy worked to the benefit of family budgets in an unexpected way. In 1979 the share of individuals' income that went on tax payments was 18.2 percent, while the share of their income provided through government transfer payments to individuals (such as social security, veterans' benefits, welfare assistance) was 12.4 percent. The 5.8 percent differential was not far out of line with the approximately 6 percent differential that pertained in the 1950s and 1960s. By 1986, the total tax payment of individuals was still 18.2 percent because the social security tax increases counterbalanced the effects of ERTA, but transfer payments had risen to 13.4 percent of individual income. This produced a differential of 4.8 percent, making an extra 1 percent of income available for consumer spending compared with 1979. The third factor that financed real consumption growth without real earnings growth was the reduction that took place in individual saving. Americans saved 7.2 percent of their after-tax income on average from the 1950s to the 1970s. This rate declined to 6.5 percent on average from 1981 to 1984 but then fell steadily to 3.7 percent by 1987. In other words the Reagan economic recovery was fueled in part by a decline in saving, which Reaganomics had originally promised to boost.³⁴

Debtor Nation

One of the most significant economic consequences of huge budget deficits in the Reagan era was their impact on national saving. Until 1980 private

saving by individuals and business, though never historically strong in comparison with other nations, more than offset the relatively small deficits that the federal government ran almost continuously since 1945. However the growth of federal "dissaving" in the shape of mammoth deficits compounded the problem of the decline in private saving in the 1980s. The overall rate of national saving (private savings minus government borrowing) underwent a precipitous decline from a yearly average of 7.7 percent in the 1970s to 3 percent in the late 1980s.³⁵ Left to rely on its own resources, the United States would have experienced a comparable decline in private investment as a result of the collapse of national savings, but it made up the deficiency through attracting a massive inflow of foreign capital.

Thanks to the collapse of national saving, the United States was transformed from a creditor with net foreign assets of \$141 billion to a debtor with net foreign liabilities of \$111 billion in 1985, a swing of \$250 billion in just four years. Foreign capital was attracted to the United States by interest rates that were some 2 percent above those of Western European countries and Japan in the mid-1980s. On average the real short-term interest rate in the United States was 4.9 percent in the 1980s compared with 0.79 percent from the 1950s through the 1970s. The difference reflected America's need to borrow from abroad in the later period and the adequacy of its domestic savings in the earlier era. At one juncture in 1983 Paul Volcker had criticized as excessive a Fed staff projection that the net inflow would need to reach \$75 billion a year to cover America's needs. In the peak year of 1985, however, it went as high as \$103 billion.³⁶

Higher interest rates resulted in a strong dollar that led in turn to a growing trade deficit. Between October 1979 and February 1985 the dollar rose in value by over 80 percent against a basket of eleven major currencies. America's annual merchandise trade deficit rose in conjunction from \$26 billion in 1980 to a record high of \$159 billion in 1987 before the effects of currency revaluation that had been going on for two years brought about a steady decline to \$108 billion by 1990. Benefiting from the favorable exchange rates of the early 1980s, manufactured goods from East Asia and Western Europe undercut American products not only in domestic but also in foreign markets. Foreign competition was blamed for the loss of jobs and the slow recovery of employment from the recession. Japan, with whom the United States operated a \$56 billion bilateral deficit in 1987, was singled out for particular criticism for taking supposedly unfair advantage of the situation. The inevitable consequence was the rise of protectionist sentiment in Congress, particularly among Democrats who represented blue-collar constituencies.³⁷

The Reagan administration preached the virtues of free trade as part of its free market mantra, but found excuses in its first term to do the opposite in practice. In 1981, for example, it secured Japanese agreement for "voluntary" restrictions on their automobile imports in the United States in order to head off the danger of import quota legislation.³⁸ Seizing on renewed congressional demands for protectionist measures, Treasury Secretary James Baker negotiated with Volcker's assistance the so-called Plaza Accord with

their G-5 (France, Japan, United Kingdom, and West Germany) counterparts in September 1985. This entailed a joint commitment to intervene in financial markets by means of selling dollars and buying other currencies in order to depress the value of the greenback. The dollar went into a rapid and prolonged decline that saw it fall from a peak exchange rate of 263.5 against the Japanese yen in February 1985 to 153.5 two years later. Volcker characterized this as "the most aggressive and persistent effort" to manipulate exchange rates on a global scale since the end of the Bretton Woods system of dollar-based fixed exchange rates in the early 1970s.³⁹

The Louvre Accord of February 1987 sought to extend the process of international economic coordination among G-7 nations (Canada and Italy had now been allowed to the table) by agreeing Baker's proposal for dollar stabilization in return for America's trading partners stimulating their economies to boost imports. However, this only revealed the limitations rather than the possibilities of global cooperation. It proved impossible to connect exchange rate realignment with macroeconomic adjustment. The United States would not raise interest rates to pump up the dollar's value for fear of precipitating another recession and Japan and West Germany would not lower their interest rates for fear of generating inflation. The huge differences between America's huge external account deficit and the large surpluses operated by some high-saving G-7 nations, notably Japan, also made coordination difficult.⁴⁰

An official report later suggested that fears of a foreign dollar strike in response to the declining value of America's currency was a factor in bringing about the stock market crash of October 19, 1987. Whether justified or not, this bespoke of growing concern at the erosion of America's economic sovereignty in a new era of global interdependence.⁴¹ Prompt action by the Federal Reserve to guarantee banks necessary liquidity ensured that the crash did not precipitate a new recession. Nevertheless, the stock market collapse prompted political compromise between the Reagan administration and the congressional Democrats over the Omnibus Trade and Competitiveness Act of 1988. This was the first comprehensive trade bill since the protectionist Smoot-Hawley Act of 1930 that was widely blamed for precipitating global depression. It originally contained a Democratic proposal for imposition of quotas on countries running a large bilateral surplus with the United States. Fears of provoking a trade war at a particularly critical moment for the global economy led to its substitution with a provision authorizing negotiations with countries that operated unfair trade barriers and retaliation only if talks failed.⁴²

In meeting the unexpected challenges posed by America's new status as a debtor nation, the Reagan administration's efforts to promote international coordination of exchange rates and macroeconomic policies arguably constituted its clearest deviation from the free market ethos proclaimed by Reaganomics. This intervention did nothing to cure the fundamental problem of America's external imbalance that underlay its changed position in the international economy. The solution required an increase in national saving,

which was best achieved by reducing the deficit not by manipulating currency rates.

The Legacy of Reaganomics

Since Reaganomics was not true to its own self in many respects, it is hardly surprising that its legacy has been ambiguous. The New Deal had pursued an inconsistent and shifting macroeconomic strategy before settling belatedly on a form of Keynesianism, but it had never started with a coherent blueprint in the manner of Reaganomics. It was World War II that provided the laboratory for the successful testing of Keynesian policies whose efficacy remained in question at the end of the 1930s. Reaganomics did not experience a comparable consolidation in the 1990s. Instead, what became known as Clintonomics offered a highly successful variant to the macroeconomic policies of the 1980s.

Bill Clinton's economic policy incurred liberal criticism for being Reaganomics Mark II, but it was distinctive in important regards.⁴³ Most significantly, it developed a different fiscal-monetary combination in economic management. This featured monetary relaxation and fiscal tightness, the reverse of the Reagan-era pattern. The transition from Reaganomics actually began during George H.W. Bush's presidency. The bipartisan deficit reduction agreement of 1990, which cost Bush his no-new-taxes election pledge and split the GOP, initiated the drive for fiscal restraint that was the dominant feature of budgetary policy in the final decade of the twentieth century. Clinton's 1993 deficit reduction plan and the bipartisan budget agreement of 1997 built upon this foundation. Under Volcker's successor, Alan Greenspan, the Federal Reserve in 1990 reversed the tight money regime instituted in 1987 and hewed to a course of monetary relaxation until 1999, when it moved to douse stock market inflation. The only significant exception to this trend was a twelve-month period in 1994–1995 when Greenspan plotted a soft landing for a fast growing economy.⁴⁴

Aided by a benign monetary regime, the United States entered a remarkable period of economic growth that benefited from an investment revolution absent in the 1980s. Between 1996 and 2000, the unemployment rate fell from 5.6 percent to 4 percent, well below the 1984–1988 average of 6.6 percent, inflation kept on its lowest track since the 1950s, and productivity growth almost doubled to 2.7 percent. Broader changes in the economy—the advent of new technology, globalization, and well-functioning venture capital markets—underlay this success, but economic management played its part. Two Democratic economists, Alan Blinder of Yale and Janet Yellen of Berkeley, whom Clinton appointed to serve on the Federal Reserve Board of Governors, argued that the experience of the 1990s offered different lessons to those of the 1980s. First, tight budgets and easy money created a pro-investment macroeconomic climate by holding down real interest rates. Second, "contractionary" fiscal policy did not harm economic growth because the

resultant decline in inflationary expectations encouraged the bond market to relax long-term interest rates and the decline of government borrowing had supply-side benefits of freeing up loan finance for private use. Finally, Greenspan's successful manipulation of interest rates disproved Paul Volcker's contention that fine-tuning to achieve an appropriate trade-off between inflation and unemployment was impossible.⁴⁵

Economic growth in combination with deficit reduction measures brought about a balanced budget much sooner than expected. The federal government operated four consecutive surplus budgets from FY1998 to FY2001 for the first time since the 1920s. This was achieved through a reversal of Reagan's budgetary priorities. The end of the Cold War facilitated a significant reduction of defense spending from 5.6 percent GDP in FY1989 to 3 percent in FY2000. The Democrats, moreover, won the central political battle of the 1990s to balance the budget at a high rate of revenue that protected domestic program outlays over Republican preferences to do so at a low level of revenues that would require domestic retrenchment. In the balanced budgets of FY1998–2001 receipts averaged 20.2 percent GDP, a level unmatched since the peak tax years of World War II in FY1944–1945 (average 20.7 percent GDP).⁴⁶

George W. Bush's attempt to renew Reaganomics only appeared to squander the legacy of Clintonomics. The Bush tax cuts embodied in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 sought to revive an economy that had been plunged into a brief but sharp recession by the dotcom collapse and the 9/11 attacks in 2001. The combination of recession, tax cuts, and increased security expenditures to fund the war on terror at home and abroad transformed the decade of surpluses that seemed possible at the dawn of the twenty-first century into a new age of deficits. Between FY2000 and FY2004 the budget moved from a surplus of 2.4 percent GDP to a deficit of 3.6 percent GDP. This fiscal deterioration of 6 percent GDP was almost comparable to the Depression-era deterioration of 6.7 percent GDP from FY1930 to FY1934.⁴⁷

Bush proved a stouter supply-sider than Reagan had been. The bulk of his tax cuts benefited upper-income groups and business to boost investment growth. The richest 1 percent of taxpayers received 45 percent of the benefits of the 2001 tax reduction, while the poorest 60 percent received just 13 percent. Among other inducements, the 2003 measure reduced the maximum tax rate on capital gains and dividends. Nevertheless, Bush's promise that his tax cuts would pay for themselves through economic growth was as empty as his predecessor's. In 2007, U.S. Treasury data suggested that they had recouped just 7 percent of their \$1.1 trillion costs.⁴⁸

The tax cuts indicated that the Bush political economy had moved in the Reaganite direction of fiscal expansion. In contrast to the 1980s, monetary policy also moved in the same direction. Ongoing productivity gains from the new technology and the capital-equipment investment boom of the 1990s countered the renewal of inflationary pressures. Moreover, the

depressing effect of renewed budget deficits on national saving did not necessitate a return of high real interest rates to attract foreign capital. The American consumer market had become the engine of global economic growth.

The export-driven economies of East Asia, led by the People's Republic of China, built up dollar reserves in the form of Treasury securities and other investments to maintain currency exchange rates that ensured competitive price levels for their products in the United States. America's current-account deficit (mainly comprising its trade deficit, net interest liabilities on its international investment balance) consequently grew to \$856 billion in 2006, equal to 6.5 percent GDP and far in excess of the Reagan-era peak of 3.5 percent GDP in 1987. Many analysts questioned the sustainability of this external imbalance and worried about the vulnerability of a foreign dollar strike.⁴⁹ More immediately, the availability of cheap credit inflated the housing market and created a mountain of individual debt. Concerns about this eventually produced U.S. stock market turbulence in 2007 that had ripple effects throughout the world.⁵⁰

Conclusion

In defense of Reaganomics, its supporters can justifiably argue that it conquered inflation, revived confidence in the American economy's capacity for growth, and freed the market from the unproductive aspects of big government. In this regard, it arguably laid the foundations for the successes of the 1990s. However, its long-term policy influence was more open to doubt. Clintonomics offered a significantly different variant and Bush's recalibration of Reaganomics has served to revive concerns about the problems associated with the original. Keynesianism enjoyed a heyday of some forty years before its failure to conquer stagflation discredited it. The problem that Reaganomics exacerbated and that might ultimately cast a shadow over its claim to a positive historic legacy is its effect on national saving, the seed corn for America's economic future.

The national savings rate has never truly recovered from the decline of the 1980s. Even Clintonomics failed in this regard. Its reversal of public dissaving was more than offset by a rapid decline of private saving in the late 1990s as Americans cashed in on the consumer and stock market booms.⁵¹ By 2006 the United States was consuming nearly four-fifths of the savings that the rest of the world did not invest at home, equivalent to more than \$2 billion a day. The growing reliance on foreign savers to make up the shortfall in domestic savings has created an unprecedented imbalance in America's external accounts that logic suggests is unsustainable. The day of reckoning that contemporary skeptics warned would be the consequence of Reagan's economic policies never came in the 1980s but the United States may yet have to face it if the fundamental problem bequeathed by Reaganomics remains unsolved.

Notes

1. Ronald Reagan, *An American Life* (London: Hutchinson, 1990), 333.
2. For Reagan's statements of his economic philosophy, see two collections edited by Kiron K. Skinner, Annelise Anderson, and Martin Anderson, *Reagan: A Life in Letters (RLIL)* (New York: Free Press, 2003), esp. 292–326; and *Reagan's Path to Victory: The Shaping of Ronald Reagan's Vision: Selected Writings* (New York: Free Press, 2004).
3. U.S. Congress, Joint Economic Committee, *The Great Expansion: How it was Achieved and How it Can be Sustained, Growth and Prosperity Series*, Vol. 4, 106th Congress, Second Session, April 2000, 5. See also Lawrence Lindsay, "The Seventeen-Year Boom," *Wall Street Journal*, January 27, 2000.
4. Quoted in John Cassidy, "Tax Code," *New Yorker*, June 9, 2004, 9.
5. James Tobin, "Reaganomics in Retrospect," in B.B. Kymlicka and Jean V. Matthews, eds., *The Reagan Revolution?* (Chicago: Dorsey Press, 1988), 103. See, also, e.g., Benjamin Friedman, *Day of Reckoning: The Consequences of American Economic Policy under Reagan and after* (New York: Random House, 1988); Robert Lekachman, *Visions and Nightmares: America after Reagan* (New York: Macmillan, 1987); and Haynes Johnson, *Sleepwalking through History* (New York: Norton, 1990).
6. Robert M. Collins, *Transforming America: Politics and Culture during the Reagan Years* (New York: Columbia University Press, 2007), 87–91.
7. These statements of Reaganomics are reproduced in: Martin Anderson, *Revolution* (San Diego: Harcourt Brace Jovanovich, 1988), 114–121; and James Tobin and Murray Weidenbaum, eds., *Two Revolutions in Economic Policy: The First Economic Reports of Presidents Kennedy and Reagan* (Cambridge: MIT Press, 1988), 291–317.
8. Paul Volcker, "The Role of Monetary Targets in an Age of Inflation," *Journal of Monetary Economics* 4, No. 4 (1978): 329–339; W. Carl Biven, *Jimmy Carter's Economy: Policy in an Age of Limits* (Chapel Hill: University of North Carolina Press, 2002), 237–252. For a journalistic account of Volcker's Fed, see William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York: Simon & Schuster, 1987).
9. Michael Mussa, "U.S. Monetary Policy in the 1980s," in Martin Feldstein, ed., *American Economic Policy in the 1980s* (Chicago: University of Chicago Press, 1994), 86–114; Friedman, *Day of Reckoning*, 147–149; John W. Sloan, *The Reagan Effect: Economics and Presidential Leadership* (Lawrence: University Press of Kansas, 1999), 225–229.
10. Aaron Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley: University of California Press, 1989), esp. chapters 9–11, 13.
11. Alan Greenspan, untitled enclosure, "Briefing Book for Long-Range Planning Meeting," Camp David, February 5, 1982, Box 1, Richard Darman Files, Ronald Reagan Library (RRL); *Public Papers of the President of the United States: Ronald Reagan 1982* (henceforth *PP: Reagan*), 1030, 1052.
12. Richard Darman, *Who's in Charge: Polar Politics and the Sensible Center* (New York: Simon & Schuster, 1996), 118–119.
13. Mussa, "U.S. Monetary Policy in the 1980s," 115–131.
14. See, in particular, Sloan, *The Reagan Effect*, 229–235, 237–244; and Friedman, *Day of Reckoning*, 206–207.
15. See Volcker's comments in "Monetary Policy," in Feldstein, *American Economic Policy in the 1980s*, 145–151, 157–164 (esp. 162).
16. Reagan to Martin Feldstein, July 21, 1983, and to Arthur Burns, February 22, 1984, in *RLIL*, 317, 319. For Council of Economic Advisers chair Feldstein's advocacy of deficit reduction, see his memoranda to Reagan, "Tax Increases and Economic Recovery," October 18, 1983, and "Deficits and Inflation," January 8, 1984, Martin Feldstein Files, OA9815, RRL.
17. James Savage, *Balanced Budgets and American Politics* (Ithaca, N.Y.: Cornell University Press, 1988), 229–231; Amos Kiewe and Davis W. Houck, *A Shining City on a Hill: Ronald Reagan's Economic Rhetoric, 1951–1989* (New York: Praeger, 1991), 165–173.
18. Herbert Stein, *Presidential Economics: The Making of Economic Policy from Roosevelt to Clinton*, third, revised ed. (Washington D.C.: AEI Press, 1994), 326–330.
19. Friedman, *Day of Reckoning*, 194–198, 206–208; Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations* (New York: Norton, 1994), 126–127.
20. *PP: Reagan 1981*, 139, 178, 200, 468, 510, 557–558, 567; David Stockman, *The Triumph of Politics: Why the Reagan Revolution Failed* (New York: Harper & Row, 1986), 272.
21. Stockman, *The Triumph of Politics*, 306–321; William Greider, "The education of David Stockman," *Atlantic Monthly* (December 1981): 27–54.
22. For early expressions of this belief, see Speech to the Phoenix, Arizona, Chamber of Commerce, March 30, 1961, *A Time for Choosing: The Speeches of Ronald Reagan, 1961–1982* (Chicago: Regnery Gateway, 1983); "Inaugural Address as Governor of California," January 5, 1967, <http://www.cnn.com/SPECIALS/2004/reagan/stories/speech.archive/cal.inaug.html>.
23. For contrasting views of this theory, see Stein, *Presidential Economics*, 245–247, and Robert Bartley, *The Seven Fat Years and How to Do it Again* (New York: Free Press, 1992), 57–59, 169–173.
24. Reagan once horrified Council of Economic Advisers chair Martin Feldstein by claiming that no tax increase in U.S. history had generated increased revenues but every tax cut since World War I had done so. The latter responded with a memorandum demonstrating every tax increase since 1917 had increased revenues. See Stockman, *The Triumph of Politics*, 374; Feldstein to Reagan, "Tax Rates and Tax Revenue," January 10, 1984, Martin Feldstein Files, OA9815, RRL. He restated his belief in the revenue benefits of tax cuts in *An American Life*, 232–233.
25. Based on calculations in Dennis S. Ippolito, *Uncertain Legacies: Federal Budget Policy from Roosevelt through Reagan* (Charlottesville: University Press of Virginia, 1990), 65.
26. Council of Economic Advisers, *Economic Report of the President, January 1982* (Washington D.C.: GPO, 1982), 122.
27. Paul Craig Roberts, *The Supply-Side Revolution: An Insider's Account of Policymaking in Washington* (Cambridge: Harvard University Press, 1984); Wendell Gunn to James Baker, "... The Last Remaining Supply-Siders," March 8, 1983, James Baker Files, Box 5, RRL.
28. For this evolution, see W. Elliot Brownlee and C. Eugene Steuerle, "Taxation," in W. Elliot Brownlee and Hugh Davis Graham, eds., *The*

- Reagan Presidency: Pragmatic Conservatism and Its Legacies* (Lawrence: University Press of Kansas, 2003), 155–181.
29. Michael J. Boskin, *Reagan and the Economy: The Success, Failures, and Unfinished Agenda* (San Francisco: Institute for Contemporary Studies, 1987), 158–159. See also Ronald F. King, “Introduction: Tax Reform and American Politics,” *American Politics Quarterly* 19 (October 19, 1991): 417–425.
 30. Friedman, *Day of Reckoning*, 291; Norman Ture, “The Tax Reform Act of 1986: Revolution or Counterrevolution” in David Boaz, ed., *Assessing the Reagan Years* (Washington D.C.: Cato Institute, 1988), 30, 39.
 31. John Patrick Diggins, *Ronald Reagan: Fate, Freedom and the Making of History* (New York: Norton, 2007), 338–339.
 32. Wallace C. Peterson, “The Silent Depression,” *Challenge* (July–August 1991): 29–34. For a more detailed exposition, see the same author’s *Silent Depression: The Fate of the American Dream* (New York: Norton, 1994).
 33. These data are drawn from National Income and Product Accounts. In a demonstration as to how statistics can be manipulated, if 1979 is taken as the point of comparison—because consumption was affected by recession in 1980—then the after-inflation gain in per capita spending was 1.8 percent a year, that is, 0.1 percent less than in 1973–1979.
 34. This discussion is largely based on Friedman, *Day of Reckoning*, 150–158.
 35. Krugman, *Peddling Prosperity*, 126.
 36. Paul Volcker and Toyoo Gyohten, *Changing Fortunes: The World’s Money and the Threat to America’s Leadership* (New York: Random House, 1992), 178–179, 248. For cogent discussion of the implications of America’s external indebtedness in the 1980s, see Sloan, *The Reagan Effect*, 194–224.
 37. Stephen Grubagh and Scott Summers, “Monetary Policy and the U.S. Trade Deficit,” in Joseph Hogan, ed., *The Reagan Years* (Manchester: Manchester University Press, 1990); Jeffrey Frankel, “The Making of Exchange Rate Policy in the 1980s,” in Feldstein, *American Economic Policy in the 1980s*, esp. 295–302.
 38. Stockman, *The Triumph of Politics*, 155–58; I.M. Destler, *American Trade Politics*, 2nd ed. (Washington D.C.: Institute for International Economics, 1992), 178.
 39. Volcker and Gyohten, *Changing Fortunes*, 229. See also Yoichi Funabishi, *Managing the Dollar: From the Plaza to the Louvre*, 2nd ed. (Washington D.C.: Institute for International Economics, 1989). For James Baker’s recollections, see his memoir (with Steve Fiffer) *Work Hard, Study...and Keep Out of Politics: Adventures and Lessons from an Unexpected Life* (New York: Putnam, 2006), 426–442.
 40. Volcker and Gyohten, *Changing Fortunes*, 266–268; “The Making of Exchange Rate Policy in the 1980s,” 306–309.
 41. R. Taggart Murphy, “Power without Purpose: The Problem of Japan’s Economic Dominance,” *Harvard Business Review* 67 (March–April 1989): 72–74.
 42. Bob Woodward, *Maestro: Greenspan’s Fed and the American Boom* (New York: Simon & Schuster, 2000), 36–47; Destler, *American Trade Politics*, 95.
 43. For a critique, see Michael Mcropol, *Surrender: How the Clinton Administration Completed the Reagan Revolution* (Ann Arbor: University of Michigan Press, 1998).

44. Alan S. Blinder and Janet L. Yellen, *The Fabulous Decade: Macroeconomic Lessons from the 1990s* (New York: The Century Foundation Press, 2001), 5–33; Iwan Morgan, “Jimmy Carter, Bill Clinton and the New Democratic Economics,” *Historical Journal*, 17 (December 2004): 1015–1039.
45. Blinder and Yellen, *The Fabulous Decade*, 83–86. See also Gregory Mankiw, “U.S. Monetary Policy in the 1990s” and Douglas Elmendorf, Jeffrey Liebman, and David Wilcox, “Fiscal Policy and Social Security in the 1990s,” in Jeffrey Frankel and Peter Orszag, eds., *American Economic Policy in the 1990s* (Cambridge: MIT Press, 2002), 19–43, 61–119, respectively.
46. Dennis S. Ippolito, *Why Budgets Matter: Budget Policy and American Politics* (University Park: Penn State Press, 2003), 258–289.
47. Richard Kogan and Robert Greenstein, “President Portrays Social Security Shortfall as Enormous, but his Tax Cuts and Drug Benefit Will Cost Five Times as Much,” *Center on Budget and Policy Priorities*, March 11, 2006. For analysis of budgetary change, see Iwan Morgan, “The Bush Administration and the Budget Deficit,” in Iwan Morgan and Philip Davies eds., *Right On? Political Change and Continuity in George W. Bush’s America* (London: Institute for the Study of the Americas, 2006), 111–130.
48. David Rosenbaum, “Doing the Math on Bush’s Tax Cut,” *New York Times*, February 15, 2001, A12; James Horney, “A Smoking Gun: President’s Claims that Tax Cuts Pay for Themselves Refuted by New Treasury Analysis,” *Center on Budget Policy and Priorities*, July 27, 2006.
49. Larry Summers, “America Overdrawn,” *Foreign Policy* (July/August 2004): 47–49; Brad Setser and Nouriel Roubini, “How Scary is the Deficit: Our Money, Our Debt, Our Problem,” *Foreign Affairs* (July/August 2005): 194–200.
50. Andrew Clark and Larry Elliott, “Market Turmoil Grows as Leading U.S. Lender Seeks Emergency Aid,” *The Guardian*, August 17, 2007, 26; Daniel Gross, “The New Money Pit: Why the Housing Market Will Only Get Worse,” *Newsweek*, September 10, 2007, 36–37.
51. Elmendorf, Liebman, and Wilcox, “Fiscal Policy and Social Security in the 1990s,” 76.

