Surrender
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In 1979 the Federal Reserve announced that it was no longer going to “target” interest rates but would instead concentrate on controlling the growth of the money supply. With this decision, the Central Bank was announcing its conversion to monetarism. Henceforth, monetary policy would consist of controlling the rate of growth of money and letting the market determine interest rates.

This was the year of the second surge in oil prices (the first had occurred in 1973–74). The Iranian revolution had occurred in the beginning of the year, and the initial disruption of oil flows led to a big increase in prices. Just as in 1973–74, that produced an upward surge of inflation in the United States.¹

Meanwhile, the international value of the dollar fell from 1976 through 1979,² and by the end of 1979, central bankers from the other advanced countries of the world were insisting that the United States government do something to stop its persistent inflation and the declining dollar. The reasons are instructive. The declining dollar was reducing the real value (purchasing power) of the dollar reserves held by foreign central banks. Recall that the entire international payments system since World War II had been dependent on the dollar as the major international currency. Even when the major economies of the world had gotten onto their feet in the 1950s, the dollar remained the most important international currency because it was rigidly tied to gold at the price of thirty-five dollars an ounce. The stability of the dollar price of gold meant that central banks could build up dollar deposits for future international purchases and have confidence that they would be accepted elsewhere in the world years into the future.

Even after the dollar price of gold began to rise in the early 1970s, the United States as the largest single economy in the world still remained the logical source of international currency reserves. If the
rate of inflation in the United States were not high relative to rates elsewhere in the world, then the dollar would remain a good reserve currency. Thus, the Organization of Petroleum Exporting Countries continued to price oil in dollars, even after the significant U.S. inflation of 1974–75.

Money plays three roles. It is a medium of exchange, a standard of value, and a store of value. We use money for the convenience of buying milk, gasoline, clothing, theater tickets, and automobiles and for making investments. Without a universally accepted medium of exchange, each time we wanted milk or gasoline, we would need to find a dairy farmer or oil refiner who needed something we could supply (in my case, economics lessons!). We also use money for the convenience of getting paid in something universally accepted. Otherwise, I would have to peddle this book only to dairy farmers, oil refiners, and others who had what I wanted.

Money’s role as a store of value is also quite important. When I put my month’s salary in the bank, I am confident that I can leave it there for the entire month and maybe more before I need it to pay the next bill. I do not need to worry that by the time I am ready to use it to buy something, the price of that something will have doubled or tripled or worse.

In international economic relations, the dollar was both the principle medium of exchange and the principal store of value, even after the dollar price of gold began to rise. People from, say, Austria could purchase something produced in France even if they didn’t have any French francs as long as they had dollars. The United States experienced less inflation than other advanced countries between 1973 and 1976, and that helped the dollar retain its role as an international store of value.³

However, during 1978 and 1979, foreign central bankers began to suspect that the Fed was letting the dollar slide in value. There even was a term for this policy, “malign neglect.” The problem was that for American policymakers there was a contradiction involved in the desire to keep the dollar an important international currency (which required stability in its role as a store of value) and the desire to maintain the international competitiveness of American export goods (and the domestic competitiveness of goods that had significant competition from imports). A declining dollar produced declining prices for American exports and rising prices for imports into the United States. However, the declining dollar and worry about future declines led some to
begin to question the long-run stability of the entire international-pay-
ments system.

In 1973, the international community had abandoned all pretense
of maintaining a system of fixed exchange rates among currencies with
the dollar anchored to gold. In 1974 and 1975, the price of gold aver-
aged just over $160 per ounce, ranging from a low of $117 to a high of
$194. The average price fell in 1976 and rose in 1978. The next year saw
the largest percentage increase in the average price since 1974, the year
of the previous oil price shock. The average for all of 1979 was $307,
but it was well above that by the end of the year. The highest recorded
price for the year was $517 in December. This price rise was a sign that
skittish international investors were beginning to hedge against prob-
lems with all currencies, not just weak ones. By January 1980, the price
had peaked at $850, and some were beginning to seriously consider
whether to stem worldwide inflation it would be necessary to reestab-
lish an anchor whereby the dollar would be permanently worth some
amount of some commodity, most likely gold.

However, despite such skittishness, there was a positive side for the
U.S. economy. Lowering the prices of American exports while raising
the dollar price of American imports could play a role in reducing the
trade deficit. A trade deficit occurs when Americans purchase more
abroad than foreigners purchase in the United States, resulting in a net
outflow of dollars. This outflow reduces aggregate demand, because
the dollars spent overseas do not employ Americans and do not (for
the most part) increase the income of Americans. In 1977, the trade
deficit was 1.2 percent of GDP. The previous high had occurred in
1972, when it was .6 percent. By 1980, the decline in the value of the dol-
lar had reduced the trade deficit to near .5 percent of GDP.

On balance the reduced trade deficit did not outweigh the dangers
to the international payments system that persistent U.S. inflation was
creating. Thus, the newly appointed chairman of the Federal Reserve
Board, Paul Volcker, decided to abandon incremental interest rate
increases in favor of something dramatic that would shock the finan-
cial markets out of their inflationary expectations. On September 28,
1979, he persuaded his colleagues on the Federal Reserve Board to tar-
get the money supply instead of interest rates. After a few days at a
major international conference, he returned to the United States,
where the full Federal Open Market Committee agreed to the policy
change.

The long-run impact of this change was that interest rate increases
could henceforth be identified as “market driven,” not caused by Fed policy. The willingness to hold the line on monetary growth and do nothing no matter how high interest rates went signaled full commitment to the goals of crushing inflation and preserving the international-reserve status of the dollar. In a statement before the Joint Economic Committee of the Congress, eleven days after the announcement, Volcker spelled out the goal of what he called “the new measures”: “Above all, [they] should make abundantly clear our unwillingness to finance a continuing inflationary process.”

The “Monetarist Experiment”

Tracking the immediate impact of Federal Reserve monetary policy requires observing a crucial interest rate, the Federal Funds rate. Every day, at the close of business, commercial banks in the Federal Reserve System must have a certain percentage of their outstanding deposits either on hand as reserves or on deposit at a local Federal Reserve Bank. These reserves cannot be invested by the bank either in government securities or in loans to the private sector. They just have to sit there. Since these reserves produce no income for the bank, banks want to minimize them. On the other hand, they violate the law if they do not have the required level of reserves at the close of business every day.

The Federal Funds market is one in which banks whose reserves exceed the legal requirement make overnight loans to banks whose reserves are below the legal requirement. The interest charged on those loans is called the Federal Funds rate. When the Fed engages in monetary manipulations to alter the availability of reserves to banks, it changes the availability of these overnight monies, thereby altering the interest rate.

It is not surprising, therefore, to see the Federal Funds rate jump from an average of 10–11 percent during the first three quarters of 1979 to an average of 13.58 percent in the last quarter of 1979. Meanwhile, the rate of growth of money (M1, the narrowest measure), which had been rising since 1974, peaked at 8.2 percent per year in 1978 before falling to 6.8 percent in 1979. Then, the Fed was able to hold the line on M1 growth for two more years. Perhaps just as important as what the Fed did was what the Fed said. The next “Monetary Report to Congress” stated,

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Monetary policy clearly has a major role to play in the restoration of price stability. . . . inflation can be sustained over the long run only if the resulting higher level of dollar expenditures is accommodated through monetary expansion. The Federal Reserve is determined not to provide that sustenance, but will adhere instead to a course, in 1980 and beyond, aimed at wringing the inflation out of the economy over time. . . . If recessionary tendencies should develop during 1980 . . . the steady anti-inflationary policy stance represented by continuing restraint on growth in the supply of money and credit would be consistent with an easing of conditions in financial markets, as demands for money and credit weaken.\textsuperscript{12}

In addition to promising to adhere to this policy until inflation was defeated, the Fed also promised that declines in interest rates would only occur if the demand for credit slackened. There would be no greater increases in the supply of money and credit, even in the case of a recession.

Interestingly enough, both M2 and M3 (broader measures of the money supply) did not respond to this policy change. From 1979 through 1981, the rate of growth of both measures of the money supply increased.\textsuperscript{13} Meanwhile, the Federal Funds rate fluctuated wildly.\textsuperscript{14} It reached its peak in June 1981 at 19.1 percent. The recession began in August 1981, causing the rate to fall to 12.37 percent by year’s end. In the face of a worsening recession, for the first seven months of 1982 the Fed stuck to its restrictive policy, and the rate never fell below 12.5 percent. Finally, in August 1982, the rate began to fall, reaching a nadir of 8.51 percent in February 1983.\textsuperscript{15}

By the middle of 1982, the Fed had abandoned its “monetarist experiment” and let M1 rise faster than its initial target for that year. At the end of that year, the Fed was talking about maintaining a concentration on “monetary aggregates,” but in fact the stringent adherence to monetary targets was honored in the breach. M1 growth rose to 8.7 percent in 1982, to 9.8 percent in 1983, fell back to 5.9 percent in 1984, and rose dramatically to 12.3 and 16.9 percent in 1985 and 1986.\textsuperscript{16} The Federal Funds rate rose to another peak in August 1984 (11.64 percent) before beginning a long decline to 7.53 percent in 1985 and 5.89 percent in 1986.

Now it is important to understand that these numbers for M1 growth and for the Federal Funds rate are introduced merely to show the direction of Fed policy. How did the economy respond? The rate of inflation peaked in 1980 and then began to fall.\textsuperscript{17} The Fed’s control
over the money supply led to a sharp rise in all interest rates in 1981. As mentioned above, the Federal Funds rate peaked at 19.1 percent in June. An important interest rate for the business sector, the prime rate peaked at 12.5 percent in January, and mortgage rates peaked at 16.38 percent in November.\(^{18}\) Real interest rates also took a dramatic jump upward in 1981.\(^{19}\) By any measure, therefore, the Fed succeeded in making monetary policy very restrictive up to the end of 1982. At that point, fears of a worldwide default on loans by Third World countries unable to service debts to U.S. and other international banks at the sky-high interest rates then prevailing, coupled with fears that the recession might lead to a major depression, temporarily overcame the Fed’s desire to fight inflation at any cost.

**Freeing Interest Rates from Controls**

Another very important change occurred in 1980 that would have tremendous implications for the impact of monetary policy over the next decade. In March 1980 Congress passed the Depository Institutions Deregulation and Monetary Control Act. The principal elements of the bill gave the Fed a lever of control over banks that were not members of the Federal Reserve System. The bill imposed reserve requirements on all banks. It also removed all interest rate ceilings and repealed Regulation Q, a rule with which the Fed had controlled the interest rates of commercial banks and savings and loan institutions, preserving a differential that gave savings and loans an advantage in attracting small savers’ deposits. Though no one realized it at the time, this law was the first step toward the complete deregulation of the savings and loan sector of the economy, with consequences that we are still living with today.\(^{20}\)

Regulation Q in effect kept free markets from determining certain crucial prices—that is, interest rates. Economists usually are opposed to any form of price control. Economics textbooks attempt to show that minimum-wage laws, rent control, price controls on gasoline, “usury” laws (which put caps on interest rates), and so forth result in an artificial shortage of, and an inefficient distribution of, the good or service with the controlled price.

The argument is based on supply and demand. The price and quantity sold of any item depend on the number of people who want to buy it (and how many each wants) at various alternative prices,
matched up against the different quantities of the item that producers are willing and able to offer for sale at alternative prices. People willing to pay a higher price for a product are viewed as gaining a greater satisfaction from it than those willing to pay only a lower price. Meanwhile, the willingness of producers to offer quantities of an item is constrained by the scarcity of the resources used in producing it. Thus, higher prices are necessary to cover the higher costs of increasing production. At only one price, the equilibrium, will the total quantity offered for sale by the producers be exactly balanced by the total quantity purchased by consumers. At a lower price, a shortage will develop, showing that both producers and consumers would be happier if a higher quantity were offered for sale at the higher price. If that lower price cannot rise toward the equilibrium (say with price controls on gasoline), that shortage will persist. The clear conclusion is that the artificial shortage interferes with the efficiency of the market. The purpose of the market is to stretch our limited resources to satisfy as much of our unlimited wants as possible. The existence of such artificial shortages clearly interferes with our efforts to make our limited resources satisfy us as much as possible.  

Before returning to Regulation Q, let us examine other examples of price controls to see how economists have argued against them. Rent control typically limits what can be charged to tenants in certain apartment buildings. The existence of these limits allegedly signals to builders and owners of buildings that they will not be able to receive high-enough incomes to justify increasing supply. This leads to a slower growth in housing than would exist without the controls. Rent control is often blamed for the deterioration of existing housing stock, as owners feel the rate of return is too low to justify ongoing maintenance.

An artificially high price, such as a minimum wage, according to this approach, reduces the willingness of employers to hire low-skilled workers and raises the unemployment rate of such workers. That is, there will be a surplus of workers willing and able to work at the artificially high wage. Employers would be willing and able to hire more workers if the wage would fall, and some of the currently surplus workers would be willing and able to work if the wage would fall. Thus, the artificially high wage reduces employment.  

Price controls on gasoline in both 1974 and 1979 produced shortages similar to those caused by rent control, according to this argument. There were long lines at the gasoline pumps. People were willing and able to buy more gasoline than they in fact could get.
When we apply this reasoning to financial markets, the conclusion is that state-imposed (and Federal Reserve–imposed) limits on the interest rates that banks can charge and pay reduce the flow of savings to those institutions and then from those institutions to borrowers. Regulation Q, for example, meant that commercial banks and savings and loan institutions could not attract deposits in competition with other lending institutions whose ability to offer interest to depositors was unconstrained. Interest ceilings on, for example, home mortgage rates had produced periods of disintermediation (periods when new lending ceases) whenever the Fed tightened up on monetary policy. Higher interest rates would push up against legal ceilings. Instead of efficiently rationing the credit among borrowers most intensely desiring the funds and therefore willing and able to pay the higher interest rates, all supply of the particular kind of credit would cease. In the case of mortgages,

It was not that borrowers such as home buyers or contractors were necessarily unwilling to pay higher interest rates—the shutdown came from investors, who refused to provide the money when they knew their returns were artificially depressed by the government ceilings. An investor who held funds in a regulated account at a savings and loan, drawing 5 percent or so, would withdraw his money and move it to another storage place, one that was unregulated and promised a much higher return.23

From the point of view of supply and demand these regulations were grossly inefficient. From the point of view of Federal Reserve control over the economy, however, this situation meant that with slight increases in interest rates, the Fed could shut off credit creation and slow, even stop, the economy. Thus Regulation Q had an upside. The downside was apparent during periods of inflation such as were experienced in the 1970s. Unregulated money market funds offered interest rates well in excess of those limited by Regulation Q. Assets in such funds tripled in 1978 to a total of $9.5 billion, growing to $42.9 billion in 1979 and to $236.3 billion by 1982.24

In repealing the Regulation Q ceilings, the 1980 law also raised the limit of insured deposits to a maximum of one hundred thousand dollars, thereby permitting savings and loans to attract large deposits with very high interest rates. In order to cover those high interest rates, S&L’s were further permitted to diversify their portfolios beyond home mortgages. Up to 20 percent of their assets could now be in con-
sumer loans, commercial paper, or corporate debt. With insurance on the deposits they took, these banks were now primed to seek out the riskiest, and therefore highest-paying, loans available. If they succeeded, they made money. If not, the depositors would be insured anyway.

An Important Implication of Financial Deregulation

Another impact of deregulation was that the Fed could no longer stop the economy quickly by driving interest rates up to the legal ceiling, thereby inducing disintermediation. From 1980 forward, the Fed would have to drive interest rates much higher in order to achieve the kind of monetary slowdown they had promised. Note how this need for higher interest rates than in the past when attempting to fight inflation was satisfied by the ostensible change of policy focus from interest rates to money growth. While higher interest rates helped restrain inflation by restraining aggregate demand, particularly in 1984, a bubble of debt kept expanding throughout the decade until the savings and loan debacle in 1989 revealed that the taxpayers had just been stuck with a $180-billion-dollar loss.

As the Federal Reserve drove interest rates higher and higher in 1981, the Reagan administration not only failed to argue against that policy, they actually supported it. In the first report by the Reagan Council of Economic Advisers the members asserted that one of the pillars of the administration’s policy was “in cooperation with the Federal Reserve, making a new commitment to a monetary policy that will restore a stable currency and healthy financial markets.” This was in marked contrast to the responses of previous administrations when confronted by tight money policies. In previous situations of anti-inflation policy, members of Congress and members of administrations would regularly complain about the Fed’s unfair high-interest policies and blame the “independent” Fed for thwarting a recovery or not doing enough to fight a recession. A few members of Congress would usually use this occasion to recommend “taking a look” at the independence of the Fed. This complaining did not occur in 1981 and in fact in did not happen until quite late in 1982. The Reagan administration made it very clear by what they said and by what they did not say that the Fed’s anti-inflation policy was acceptable, even though it was causing a recession. For example, in February 1982, with the
recession deepening, President Reagan went out of his way to support the Fed.

I want to make clear today that neither this administration nor the Federal Reserve will allow a return to the fiscal and monetary policies of the past that have created the current conditions. . . . I have confidence in the announced policies of the Federal Reserve Board. The Administration and the Federal Reserve can help bring inflation and interest rates down faster by working together than by working at cross-purposes. This administration will always support the political independence of the Federal Reserve Board.26

Unfortunately, the fiscal policy that was the ultimate result of the Reagan administration tax and spending policies did produce some “working at cross-purposes.” We turn now to the policies introduced by the Reagan administration as part of the turnaround in economic policy.

Reaganomics: The Economic Recovery Tax Act

In its first year in office, the Reagan administration made significant strides in implementing its new approach to fiscal policy and other government interventions into the economy. The two fiscal policy elements in the Reagan program are summarized by the Council of Economic Advisers as “cutting the rate of growth in Federal spending” and “reducing personal income tax rates and creating jobs by accelerating depreciation for business investment in plant and equipment.” Table 5 summarizes the changes in the personal income tax (for married couples filing jointly).

The change in tax policy had been promised in the campaign and had been on the legislative agenda at least since 1978, when Representative Jack Kemp and Senator William Roth had proposed a three-year, 30 percent across-the-board reduction in personal income tax rates. That supply-side proposal was combined with a major overhaul of depreciation guidelines, and the result was the Economic Recovery Tax Act of 1981. The council described its main impact as “shifting the burden of taxation away from capital income, thereby providing substantially greater incentives for capital investments and personal saving.”28 Note that this is not quite what supply-side economic theory had called for. Supply-siders had argued that all income should be subjected to lower marginal tax rates and that this would increase the incentives not only to save and invest but encourage workers to enter
the labor force. In other words, the supply of savings and entrepreneurship would rise, but also the supply of labor.

In fact, because of rises in Social Security payroll taxes already scheduled, between 1980 and 1985 the actual ratio of federal taxes paid on income rose for the bottom 40 percent of the population and fell for the top 60 percent of the population. For the top 5 percent of the population that fall was from an average rate of 29.7 percent in 1980 to 24.4 percent in 1985, while for the top 1 percent the fall was from 31.9 percent to 24.5 percent. Since ownership of capital is concentrated in these high-income groups, it is clear that the rate of taxation on capital income did fall quite dramatically. In 1980, while the top 20 percent of the population received 43.5 percent of the wage income, that same top 20 percent received 70 percent of the rents, interest, and dividends and 89 percent of the capital gains. By 1985, the top 20 percent had increased its share of wages (46 percent) and capital gains (94.5 percent) while suffering a negligible percentage decline in rents, interest, and dividends (to 69.5 percent).

One other important aspect of the Economic Recovery Tax Act should be mentioned. In order to avoid any future problem of bracket

### TABLE 5. Changes in the Federal Income Tax Resulting from ERTA (married couples filing jointly)

<table>
<thead>
<tr>
<th>Taxable-Income Bracket ($)</th>
<th>Tax Rate before ERTA (%)</th>
<th>1982</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–3,400</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3,400–5,500</td>
<td>14</td>
<td>12</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>5,500–7,600</td>
<td>16</td>
<td>14</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>7,600–11,900</td>
<td>18</td>
<td>16</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>11,900–16,000</td>
<td>21</td>
<td>19</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>16,000–20,200</td>
<td>24</td>
<td>22</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>20,200–24,600</td>
<td>28</td>
<td>25</td>
<td>23</td>
<td>22</td>
</tr>
<tr>
<td>24,600–29,900</td>
<td>32</td>
<td>29</td>
<td>26</td>
<td>25</td>
</tr>
<tr>
<td>29,900–35,200</td>
<td>37</td>
<td>33</td>
<td>30</td>
<td>28</td>
</tr>
<tr>
<td>35,200–45,800</td>
<td>43</td>
<td>39</td>
<td>35</td>
<td>33</td>
</tr>
<tr>
<td>45,800–60,000</td>
<td>49</td>
<td>44</td>
<td>40</td>
<td>38</td>
</tr>
<tr>
<td>60,000–85,000</td>
<td>54</td>
<td>49</td>
<td>44</td>
<td>42</td>
</tr>
<tr>
<td>85,000–109,400</td>
<td>59</td>
<td>50</td>
<td>48</td>
<td>45</td>
</tr>
<tr>
<td>109,400–162,400</td>
<td>64</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>162,400–215,400</td>
<td>68</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>215,400 and over</td>
<td>70</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
</tbody>
</table>

creep, the act included a provision that after the three years of rate cutting, all tax brackets would henceforth be indexed to the rate of inflation. That meant that each year’s previous increase in the consumer price index would be applied to the endpoints of each tax bracket. So, if the rate of inflation were 4.3 percent in 1984, each of the income levels defining the brackets in table 5 would be raised by that amount. This would guarantee that a rise in money wages to keep up with inflation would not subject a taxpayer to a higher marginal tax rate. According to tax expert C. Eugene Steuerle, this feature of ERTA provided over time the most significant level of tax relief by far. He estimated that the indexing provision saved taxpayers $57 billion between 1984 and 1990. That was half of the reduction that resulted from the combination of ERTA tax cuts and the many subsequent changes in the individual and corporate income taxes and the Social Security payroll tax for the rest of the decade.31

**Regulatory Relief**

Though the tax changes were the major focus of the supply-side wing of the Reagan economic policymaking team, they were not the only elements in the Reagan administration’s program. Murray Weidenbaum had been appointed as head of the Council of Economic Advisers, and it was obvious that this strong critic of expensive government regulation would make every effort to reduce what he believed to be a heavy burden on the private sector. Very early in the Reagan administration, Executive Order 12291 directed federal agencies “to use benefit-cost analysis when promulgating new regulations, reviewing existing regulations or developing legislative proposals concerning regulation.”32 One of the elements of this order was to force all newly proposed regulations to be approved by the Office of Management and Budget before being published in the *Federal Register.*

In addition, a Task Force on Regulatory Relief chaired by then vice president George Bush was set up to assess already existing regulations. Within the first year of operations, they looked at one hundred existing regulations and targeted over a third for elimination or revision.33 Even more important than these specific activities, the Reagan administration signaled by key cabinet appointments that it would be much more circumspect in using of existing regulations. James Watt, appointed secretary of the interior, and Anne Gorsuch
(later Burford), appointed to head the Environmental Protection Agency, were the most dramatic examples of individuals who by virtue of their attitudes toward regulations on private-sector activity would be disinclined to use the powers of their agencies to interfere with business, even if those businesses were engaging in technical violations of existing rules or statutes. In fact, over the next few years, many supporters of stronger environmental regulations called the activities of these departments “repeal by nonenforcement.” What this meant was that since the statutes governing protection of the environment, the Clean Air Act, the Clean Water Act, the new Superfund Act were not going to be repealed by Congress, the only way to reduce the burdens of regulation imposed by these acts on business was not to enforce them. This cynical view was re-enforced when one of Gorsuch-Burford’s appointees, Rita Lavelle, was found to have perjured herself before Congress on her contacts with businesses that were under investigation for pollution violations. In the ensuing controversy, Burford herself resigned.34

In the area of civil-rights enforcement, the Reagan administration pursued similar policies. The two major regulatory bodies were the Office of Federal Contract Compliance Programs (OFCCP) in the Department of Labor and the Equal Employment Opportunities Commission (EEOC). The latter was charged with processing complaints of discrimination in employment, while the former actually issued affirmative action guidelines to government contractors on the hiring of racial minorities and women. By the 1970s it had become clear to most people in the civil-rights community that it was not sufficient to outlaw overt discrimination. Subtle, hard-to-detect instances of discrimination could have the same impact as outright prohibitions against hiring, say, a woman electrician or a black firefighter. This is where affirmative action comes in.

The concept of affirmative action has been so distorted by arguments about “reverse discrimination” and “quotas” that it is useful to recall what the term actually means. It means that when a historical pattern of discrimination has left a business, an institution, or an occupation disproportionately white and/or male, the entity in question must try to remedy the imbalance. Sometimes this effort might involve vigorous advertising among groups that had previously not been hired. Sometimes it might involve serious reconsideration of the credentials required for the job. For example, clerks in stores may not need a high school education in order to do their work, and in certain
localities, requiring a high school diploma would exclude many eth-
nic minorities.

During the 1970s, the roles of both the EEOC and the OFCCP were expanded. The EEOC was given the power to sue businesses over alleged discriminatory practices. The OFCCP began to review govern-
ment contractors’ affirmative action programs before contracts were awarded. Though quotas were never imposed by these organizations, an effort was made to encourage businesses to set “goals” and “timeta-
bles” for increasing minority and/or female employment.

No matter how justified these activities might have been, even good-faith efforts to comply with the letter and spirit of the various civil-rights acts and to satisfy the EEOC and/or the OFCCP would clearly increase the costs to business. Thus, the increasing role of the government in civil-rights enforcement also fits into the Weidenbaum analysis. On top of this, as affirmative action programs became more and more intrusive, the opposition to the substance of affirmative action became stronger. Whenever a group of people are vying for a job, affirmative action involves some form of favoritism to members of a group that had been subjected to discrimination in the past. The Reagan administration, by their appointments and actions, came down strongly on the side of those who see most affirmative action as involving unfair “reverse discrimination.”

This approach neatly dovetailed with the more general view, fol-
lowing Weidenbaum, that government intervention into the hiring and promotion processes of private-sector firms imposed substantial costs on businesses. The rising costs of regulation had been blamed by many economists for at least part of the unacceptable slowdown in produc-
tivity growth in the period before Reagan’s election. When one couples the cost of compliance with civil-rights-dictated policies with the view that the impact of affirmative action is negative (because of “reverse discrimination”), the result is a requirement that the benefits of regula-
tion be carefully justified.

President Reagan appointed William Bradford Reynolds to head the Civil Rights Division of the Justice Department. He opposed the use of goals, timetables, and, of course, quotas as responses to past dis-
crimination. Reynolds told Congress,

We no longer will insist upon or in any respect support the use of quotas or any other numerical or statistical formulae designed to provide non-victims of discrimination preferential treatment based on race, sex, national origin or religion.
Nonvictims were here identified as racial minorities and/or women attempting to find jobs or achieve promotions in companies or other institutions that had practiced discrimination in the past. The Reagan administration made it clear that individuals who had not themselves been subjected to discrimination had no right to compensation.

The Reagan Justice Department attempted to get the courts to declare unconstitutional affirmative action agreements that involved fixed-percentage hiring to police and fire departments. In addition, it intervened to attempt to overturn fifty-one affirmative action plans in other governmental bodies that had fairly strict goals and timetables. At first, the courts did not support these actions, but by the end of the decade, enough Reagan appointees had been appointed to the Supreme Court to shift the burden of proof in many cases of alleged discrimination.37

In the early Reagan budgets, all areas of civil-rights enforcement suffered budget and personnel cuts. The Civil Rights Division was held to level funding (which reduced its real funding because of inflation), so that staff declined by 13 percent between the 1981 and 1983 fiscal years. The OFCCP budget fell 24 percent in real terms, and staff was cut 34 percent, while at the EEOC the (real) budget fell 10 percent and staff fell 12 percent. Note this was at a time that the population was rising, the size of the labor force was rising, and the number of complaints received was going up.

Sanctions against companies found to have wrongfully discriminated also fell dramatically. Because of the administration’s argument “that only identifiable victims should be compensated,”38 awards for back pay fell from $9 million in 1980 to less than $4 million in 1983.39 This sent a powerful message to business that the cost of engaging in discriminatory behavior (or of failing to vigorously pursue affirmative action policies) would be much lower than during the Carter years.

Clarence Pendleton, a member of the small but very prominent group of black conservatives (whose prominence was enhanced at a conference held right after the 1980 election in Fairmont, California) was appointed head of the Civil Rights Commission. Clarence Thomas, another attendee at the conference, was named head of the Equal Employment Opportunities Commission. Both organizations backed away from vigorous pursuit of affirmative action programs. Indeed, Mssrs. Thomas and Pendleton were widely quoted as opposing most forms of affirmative action, such as “set asides,” “goals and timetables,” and so forth, because they were, in their view, impossible
to enforce without violating the “color-blindness” of the civil-rights statutes and the Fourteenth Amendment to the Constitution.\textsuperscript{40}

It is safe to say, in summary, that the Reagan administration represented an entirely new climate for the regulation of business. Not only was the increase in regulations slowed, but major efforts were made to extend the deregulation that had already begun under Jimmy Carter. In 1978, airlines had been deregulated.\textsuperscript{41} In 1980, steps toward reduced regulation in interstate trucking and railroads were taken. In 1981 began the deregulation of intercity bus transportation. Following up on the 1980 banking law, new regulations were issued permitting mortgage-lending institutions to offer variable-rate mortgages as a way of protecting lending institutions from unexpected surges in inflation. In 1982, Congress passed and President Reagan signed the Garn–St. Germaine Act, which effectively decontrolled savings and loan institutions. This completed the process begun in 1980 and permitted them to compete for loans with higher interest rates and money market accounts and to diversify their assets beyond low-yield mortgages.

In the area of broadcasting, the Federal Communications Commission deregulated most commercial radio broadcasting and simplified the license-renewal application. As part of the Omnibus Budget Reconciliation Act of 1981, Congress extended the period between license renewals for television and radio stations. The rationale for these changes and for the settlement of the AT&T antitrust suit was that competition from new directions was vitiating the original rationales for regulation. In the area of television, cable TV provided new areas of competition that reduced the necessity for government regulation. In the area of telecommunications, AT&T was subject to new competition in setting long-distance rates and selling/leasing equipment and that meant the subsidy from one part of AT&T to another was not as great a concern as previously. The settlement of the suit cut AT&T loose from its monopolies of local telephone service to sink or swim in the competitive markets for long-distance service and equipment. Meanwhile, each local system would continue to be regulated at the local level.\textsuperscript{42}

According to research done by the Center for the Study of American Business, between 1981 and 1984 real dollars spent on regulation fell slightly. If we assume that the indirect costs of compliance remained in the same ratio to the budgets of regulatory agencies, this represented a real reduction in the regulatory burden on business. Even
more important, this provided a significant brake in the trend that had seen regulatory budgets more than double between 1970 and 1981.43

**Redistribution of Income**

When it came to redistribution of income, the Reagan administration’s first set of proposals contained in the Omnibus Budget Reconciliation Act (OBRA) of 1981 attempted to reduce benefits and eligibility for a number of means-tested programs. The major means-tested program that comes to mind when people think of “welfare” is Aid to Families with Dependent Children. Before it was abolished in 1996, this program was administered by the states, and thus benefits and eligibility rules varied. However, since the federal government provided a significant amount of the revenue necessary to finance the program,44 it was able to force the states to change their rules, by the device of making certain rules necessary for the receipt in federal revenues.

Since AFDC was a means-tested program, rules had to be set up to “test the means” of the potential recipients. One approach would be to restrict AFDC to people with no income, but that would create the perverse effect of encouraging people with minimal income to refrain from earning any (or hiding what they do earn) in order to qualify. Another simple procedure would be to permit people to earn income but reduce the AFDC grant one dollar for each dollar earned. This would, however, create the same disincentive to earn—at least up to the AFDC grant itself—because the recipient would be subjected to a 100 percent marginal tax rate.

So states are required to disregard some income in determining eligibility and benefits. A numerical example provided by the House Ways and Means Committee Green Book showed that before 1981, AFDC recipients with low levels of outside earnings would find their benefits reduced approximately 34 cents for every dollar of outside earnings. As a result of the passage of OBRA in 1981, the benefits were reduced on average 47 cents for every dollar of outside earnings in the first four months on welfare, and that reduction increased to 75 cents per dollar after four months.45 The administration attempted to get Congress to go further, asking that when families shared housing, the part counted as “need” for the purposes of determining eligibility and benefit level would be prorated as a percentage of the cost of that housing. They also requested that any energy assistance received by families...
be counted as income against the AFDC grant. Congress rejected these aspects of the administration proposal.

According to the Urban Institute, the changes that Congress did accept meant the AFDC program cost 14 percent less in 1985 than it would have had the changes not occurred. An administration official testified that “408,000 families lost eligibility and 299,000 lost benefits as a result of the OBRA changes. The changes saved the Federal and State governments about $1.1 billion in 1983.” These results are even more significant if we recall that 1981–82 was a period of quite substantial recession. The number of individuals in poverty increased from 29.27 million in 1980 (13 percent of the population) to 35.3 million (15.2 percent of the population) in 1983 before beginning to fall (though the percentage did not go below 13 percent until 1989). In 1980, the number of individuals receiving AFDC in an average month was 10.6 million, or 36 percent of those in poverty. By 1985, the number of AFDC recipients had risen to 10.8 million representing only 32 percent of those in poverty. Note that this was in the third year of the recovery from the recession of 1981–82. There is no question that the administration’s cuts succeeded in decreasing the availability of this means-tested program.

Another important means-tested entitlement is the food stamp program. This program is completely funded by the federal government, and the rules of eligibility are set at the federal level. The first and second Reagan budgets, as well as the Agriculture and Food Act of 1981, reduced the cost of the program, by tightening eligibility among other things. According to the Congressional Budget Office, these changes saved $7 billion for the fiscal years 1982 through 1985. The immediate impact was that in 1982, when the recession was most severe, the number of people participating in the program actually fell, while the percentage of people in poverty receiving food stamps fell from 64.7 percent in 1981 to 59.3 percent the next year. The total spending on food stamps (in inflation-adjusted dollars) also fell between 1981 and 1982. Then in 1983, the number of participants and the percentage of the poor receiving benefits increased. In 1984, the percentage of the poor receiving food stamps rose and then began a decline that continued until 1988. Meanwhile, the absolute number of participants declined from 1983 through 1988. Thus, despite the fact that the recession increased the number of people eligible for food stamps, the changes enacted in 1981 and 1982 significantly slowed participation over the next three years.
Medicaid is another important means-tested entitlement and by far the most expensive. It involves payments directly to health care providers to cover the treatment of enrollees. Anyone on AFDC was automatically eligible. In the early 1980s, approximately 70 percent of the people served by Medicaid were “AFDC-related eligibles.” By increasing the difficulty of applying for and receiving AFDC, the initial changes in 1981 reduced the real-dollar expenditures on adults and children on Medicaid for the next three years.\(^5\) In addition,

the Reagan Administration initially proposed to limit federal spending in FY 1982 to a 5 percent increase over FY 1981, with future rates of increase tied to growth in the gross national product (GNP). . . . Congress rejected the cap but passed an alternative that retained the open-ended federal match at slightly reduced rates.\(^5\)

With a decreased percentage of the poor receiving AFDC and food stamps, it would appear that more of them would join the labor force. However, research in the early 1980s showed no significant increase. The supporters of the conservative economic agenda believed that the initial cuts that occurred with OBRA was only a first step toward seriously reducing the welfare state. They constantly argued that they were taking a “long-term” approach. Reducing the attractiveness of the welfare state, except for those really cut off from the labor market, would go hand in glove with rapid economic growth and job creation.

One of the important elements in the reform of means-tested programs not adopted by Congress was a work requirement for all able-bodied adults receiving AFDC (often referred to as “workfare”). Congress settled instead for permitting states to create such programs. Such requirements, combined with benefit reductions and tightened eligibility rules, were designed to increase the incentives of welfare recipients to enter the labor force. Note that the method of instituting the benefit reductions and eligibility changes actually decreased the amount of income that could be disregarded before AFDC payments had to be reduced. By economic theory, this should reduce the incentive for people to get off public assistance and into the labor force. In the 1968 presidential campaign candidate Richard Nixon proposed a goal of “getting people off of welfare rolls and onto payrolls.” However, policymakers recognize that high rates of benefit reduction as a result of earning income discourage people from trying to earn their way off the welfare rolls. This is where the workfare requirements come in.
Concentrating benefits only on the “truly needy” (defined by two White House aides as “unfortunate persons who, through no fault of their own, have nothing but public funds to turn to”) reduces the amount available to those who earn themselves part of the way out of dependency on public funds. The only way to counteract these negative incentive on the willingness to work would be to force recipients to work. When Congress permitted states to experiment, it opened the door to such programs.

By contrast, the one means-tested entitlement that is totally appropriate from the point of view of the above definition of “truly needy” is the Supplemental Security Income (SSI) program. This program applies to the elderly poor, blind, or disabled who are ordinarily not expected to have any connection to the labor market. Thus, by the analysis advanced in chapter 3, it would be inappropriate to reduce benefits in order to induce these recipients to go to work. However, the Reagan administration made two proposals to cut this program, requests that were rejected by Congress. Congress instead enacted a significant increase in benefits over and above the automatic cost-of-living adjustment. Thus, SSI expenditures in real terms rose from 1981 to 1984, while benefits as a percent of the poverty level of income for both individuals and couples rose between 1980 and 1984 (for couples it rose to 101.8 percent of the poverty level).

The Reagan administration’s approach to the welfare state targeted some programs for total elimination. One of these was public-service employment, which would have cost $4.8 billion in 1985 had the administration and Congress made no changes in it. Community Services block grants and the Work Incentive (WIN) program would have, together, cost $1.2 billion in 1985. The Urban Institute collected the proposals as well as congressional enactments and created table 6.

In discussing the economic rationale behind focusing redistribution programs onto the “truly needy” D. Lee Bawden and John L. Palmer of the Urban Institute commented that one might have expected [the administration] to emphasize human capital investment programs—programs primarily intended to increase future productivity in the workforce. Instead, the administration proposed to reduce expenditures for these programs (education and training; public service employment, nutrition programs, Medicaid, and social services) by nearly 40 percent. Some of these programs were of questionable value and were ripe for pruning. However, in its proposals the administration appeared to distinguish

*The “Revolutionary Offensive,” 1979–84* / 89
little among more or less effective programs, even though evaluation research has demonstrated significant differences in effectiveness. In other words, there did not seem to be any consistent application of the theory of the appropriate role for government in these areas when it came time for the Reagan administration to wield the budget ax. Of the programs other than public service employment slated for major reduction—Job Corps, compensatory education, and the Women,

### TABLE 6. Estimated Outlay Changes in Means-Tested Entitlements Resulting from Reagan Administration Proposals and Congressional Actions through Fiscal Year 1984

<table>
<thead>
<tr>
<th>Program</th>
<th>Projected Outlays under pre-Reagan Baseline</th>
<th>Proposed Changes (% of baseline)</th>
<th>Enacted Changes (% of baseline)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Veterans’ compensation</td>
<td>10.7</td>
<td>-8.4</td>
<td>-0.9</td>
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<td>Veterans’ pensions</td>
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<td>-2.6</td>
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<td>Supplemental Security</td>
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<tr>
<td>Income</td>
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<td>-2.5</td>
<td>+8.6</td>
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<td>Aid to Families with Dependent Children</td>
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<td>-14.3</td>
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<td>Food stamps</td>
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<td>-51.7</td>
<td>-13.8</td>
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<tr>
<td>Child nutrition</td>
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<td>+9.1</td>
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<td>Housing assistance</td>
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<td>Low-income energy</td>
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<td></td>
</tr>
<tr>
<td>assistance</td>
<td>2.4</td>
<td>-37.5</td>
<td>-8.3</td>
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<tr>
<td>Medicaid</td>
<td>24.9</td>
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<td>-2.8</td>
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<tr>
<td>Other health services</td>
<td>1.8</td>
<td>-44.4</td>
<td>-33.3</td>
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<tr>
<td>Compensatory education</td>
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<tr>
<td>Head Start</td>
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<td>n(^b)</td>
<td>n(^b)</td>
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<td>-9.1</td>
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<td>Social services block grant</td>
<td>3.4</td>
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<td>Community services</td>
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<td></td>
</tr>
<tr>
<td>block grant</td>
<td>0.7</td>
<td>-100.0</td>
<td>-37.1</td>
</tr>
<tr>
<td>General employment</td>
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<td></td>
</tr>
<tr>
<td>and training</td>
<td>5.7</td>
<td>-43.9</td>
<td>-38.6</td>
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<tr>
<td>Public-service employment</td>
<td>4.8</td>
<td>-100.0</td>
<td>-100.0</td>
</tr>
<tr>
<td>Job Corps</td>
<td>0.7</td>
<td>-42.9</td>
<td>-7.7</td>
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<tr>
<td>Work Incentives program</td>
<td>0.5</td>
<td>-17.2</td>
<td>-35.1</td>
</tr>
<tr>
<td>Total</td>
<td>125.80</td>
<td>-37.57</td>
<td>-18.93</td>
</tr>
</tbody>
</table>


*In billions of dollars.

\(^{b}\)The dollar amount is less than $50 million.
Infants, and Children (nutrition) program—Congress resisted the administration’s proposals while letting public-service employment disappear.

Entitlements without Means Tests

When it came to what we have referred to as contributory entitlements, the Reagan administration attempted to reduce access for those who could work. They introduced stringent procedures for screening those applying for Social Security Disability Insurance (DI). Between 1980 and 1982, investigations and benefit terminations increased dramatically, and costs actually fell 10 percent. The number of disabled workers fell from 2,861,253 in 1980 to 2,468,966 in 1983 before beginning to rise. This produced a furious response in litigation from many of those denied benefits. In some cases, local U.S. attorneys stated publicly that they would refuse to defend the government in suits filed by individuals seeking to have the courts put them back on disability. In 1987 the General Accounting Office did a study of those recipients of DI who had been terminated between 1981 and 1984.

As of 1987, 63 percent of the beneficiaries who were determined ineligible for benefits . . . had been reinstated to the disability benefit rolls. . . . only about 26 percent of those found ineligible remained terminated; 58 percent of these terminated individuals (or 15 percent of those earlier found ineligible) had returned to work.

Another major reduction in entitlement payments involved unemployment compensation. According to conservative economic theory, one of the major determinants of the rate of unemployment is the generosity of unemployment compensation. The longer unemployment benefits last, the longer a laid-off worker is willing to sit around waiting for his or her old job or an equally good job in the same area. The economist would like such a worker to willingly accept a lower-paying new job, perhaps in a different industry, perhaps move to where new jobs are available. This flexibility, which is crucial, according to these economists, for the efficient functioning of the labor market, is undermined by generous and long-lasting unemployment benefits. Thus, the Reagan administration made efforts to limit the ability of states to extend the availability of unemployment compensation during the 1981–82 recession. Before 1981, a state could extend the number of

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weeks a person received unemployment compensation from the basic twenty-six-week period to thirty-nine weeks under one of two circumstances: (1) 4 percent of its labor force was out of work and collecting benefits and this represented a 20 percent increase over the state rate for the previous two years, or (2) 5 percent of its labor force was out of work and collecting benefits. As part of OBRA 1981, both of these threshold percentages were raised by 1 percent. Thus, in the 1974–75 recession, the percentage of unemployed workers receiving unemployment compensation rose from a low of 40 percent in June 1974 to a high of 80 percent in December 1975.61 By contrast, though the percentage of unemployed covered in 1980 averaged 50 percent, in the depths of the recession, 1982, the percentage was only 45 percent.62 Again, this is consistent with an economic argument that for the labor market to function well, unemployed workers must not hold out foolish hopes that a job just as good as the one lost due to plant closure or business transformation will miraculously appear. It is also consistent with a political view that sees much unemployment as voluntary, subsidized by unemployment compensation.63

When we introduced the discussion of redistribution of income in chapter 3, we noted that the Social Security retirement system was perhaps the most significant violator of the conservative economic view on income redistribution. To the extent that Social Security is a pension, it is inefficient, some economists contend, to force all workers to “buy” one specific retirement plan. To the extent that Social Security redistributes income from the working (payroll-tax-paying) generation to the retired generation without a means test, it is a serious violation of the economic principles that should govern redistribution of income.64 Martin Feldstein, later to be President Reagan’s second chair of the Council of Economic Advisers, made a very significant impact on the public-policy debate with a study that claimed that the existence of Social Security had harmed our national savings rate.65 The idea is that people assume Social Security will provide some or all of their retirement income, and thus they save less than they would have if there had been no Social Security. Meanwhile, the government, unlike a private pension plan, does not invest the savings from each individual’s contributions so that the nest egg will grow till that person withdraws it. Instead, the government takes the taxes paid by the current workers and pays it out to retired people. Thus, there is no national saving taking place within the Social Security system.

As mentioned in chapter 3, many conservative economists believe
that the Social Security system ought to become means-tested for the part that redistributes income and ought to be open to competition from other life insurance, disability insurance, and retirement plans. Currently, with one payroll tax, the worker receives one required disability, life, and employment insurance plan and is involved in significant redistribution of income, sometimes to people who don’t need it. The first stage in attempting to reduce the redistribution involved in Social Security (and reduce the budget impact of the system as well) was a proposal made in 1982 to cut back by 40 percent the Social Security benefits for those opting for early retirement (between ages sixty-two and sixty-five). There was a great outcry, and the United States Senate went on record to the tune of ninety-two to zero with a nonbinding resolution in opposition.  

After that, the Reagan administration convened a bipartisan commission chaired by economist Alan Greenspan (later to replace Paul Volcker as chairman of the Federal Reserve Board) that came up with the Social Security rescue plan of 1983. This plan “fixed” Social Security so as to balance tax revenue inflows against projected payments through the year 2030. To raise revenue, they accelerated the projected increases in payroll taxes, forced all federal employees into the Social Security system, and provided for taxation of 50 percent of benefits for single taxpayers making more than twenty-five thousand dollars a year and couples making more than thirty-two thousand dollars a year. To reduce expenditures, they provided for increases in the retirement age and delayed the cost-of-living adjustment from July 1983 to January 1984.  

Congress did agree with the administration that certain subsidies to those who didn’t “need it” should be cut back. Congress initiated or supported the reinstatement of a means test for guaranteed student loans (which were heavily subsidizing the college education of high income students) partial taxation of social security benefits for those with high incomes, and greater taxation of UI [unemployment insurance] benefits for the middle class.  

Interestingly enough, the major budgetary reduction in benefits occurred in the Medicare program, and this was a congressional initiative. Medicare is a non-means-tested entitlement available to the same population that qualifies for Social Security retirement or disability. It comes in two parts, part A, which pays for hospital and other institutional stays and is financed as part of the same payroll tax that finances
Social Security, and part B, known as Supplementary Medical Insurance, which is paid for by the premiums of participants and general revenues. SMI covers physician reimbursement among other payments. Because it is not means-tested, Medicare is subject to the same objection from the conservative-economics perspective as Social Security. In addition, Medicare is what C. Eugene Steuerle and Jon Bakija call an “open-ended” expenditure, unlike Social Security.

Analysts often apply the term open-ended to financial guarantees and subsidies, where beneficiaries of government assistance largely determine the amount and size of taxpayer subsidies. . . . In the case of Medicare, the open-ended nature of the system derives from the absence of effective limits either on total payments that will be made or on what demand will be met. . . . Social Security cash benefits are not open-ended. . . . the determination of how much is to be spent is known and determined by a fixed formula.69

The problem with such open-ended programs is that consumers tend to overconsume products for which they do not have to pay the full cost out of pocket. People enrolled in the SMI part of Medicare may pay premiums and make partial payments for the services they consume (called copayments), but since they are not charged the full cost of the services, they consume with less attention to cost and hence consume more than if they were responsible for paying the full costs.

The same problem occurs with all subsidized consumption. In some cases, such as with education services, such overconsumption is justified because people who had to pay the full cost would consume less than society wants them to. This is because, as mentioned in chapter 3, the rest of society receives important benefits when an individual consumes education services—benefits the individual cannot always capture in higher income. In the area of health, an example is widespread inoculation to prevent the spread of infectious diseases. The benefit to the individual who has her or his child inoculated is less than the total benefit to society if most or all children are inoculated. Thus, it is an appropriate role of government to subsidize the overconsumption of inoculations by people who might not purchase such a service if forced to pay out of pocket.

When it comes to personal health expenditures on doctors and hospitals, especially by the elderly, overconsumption allegedly brings few benefits to the rest of society. If there were no Medicare, individuals faced with the need to purchase medical services would be very
careful what they spent their money on. Physicians and hospitals, knowing that consumers were stretching their medical dollars as far as possible, would be careful not to price themselves out of the market. Meanwhile, those who cannot afford to purchase hospitals’ and physicians’ services in the marketplace would still have recourse to Medicaid.

From the point of view of conservative economics, the very existence of a non-means-tested, open-ended entitlement like Medicare makes no sense. Subsidizing the consumption of hospital and physician services leads to both a rapid expansion in the demand for such services and a rapid escalation of costs. Add to that the subsidy to employer-provided health insurance built into the tax system. An employee does not pay income tax on the contribution her or his employer makes to purchase health insurance, but would have to pay both Social Security and income tax on the same amount if it were paid as a wage. To give the employee the same after-tax income in dollars as the employer delivers in health insurance premium payments would cost the business the premium payment plus the Social Security and income tax rate payment applicable to that worker. Clearly, it is in the interest of both employer and employee to maximize the income of employees received in tax-exempt fringe benefits such as health insurance. In addition, there is Medicaid, which subsidizes the consumption of medical services by the poor. According to the economic conservatives, these processes whereby medical expenditures are made by third parties (that is, neither the health care provider nor the patient) inevitably lead to escalating costs and big increases in the actual production and consumption of physicians’ and hospitals’ services.

In 1968, Medicare accounted for 2.6 percent of federal expenditures. In 1981, the year before Reagan’s first budget impacted the economy, Medicare spending had risen to 5.8 percent of federal spending. By contrast, Social Security payments for pensions, survivors, and the disabled rose from 13.4 percent of federal expenditures to 20.6 percent, a rate of growth that was only half as fast. Though it was clearly important for the Reagan planners to trim Social Security, since it represented such a large part of the budget, Medicare’s rate of increase also had to be addressed. As part of the 1983 Social Security rescue plan, Congress changed the formula for the reimbursement of hospitals. According to the Urban Institute, this change “amounted to the largest reduction in social program spending resulting from a single action since the [Reagan] administration took office” (see table 7).
However, nothing was done with either the Medicare or the Medicaid program to change the open-ended nature of these entitlements.

**Shrinking the Size of the Federal Government**

One area where the Reagan administration made strong efforts to cut the absolute cost of government was in federal aid to state and local governments. For fiscal year 1982, the absolute level of federal intergovernmental grants fell from $90.1 to $83.4 billion. The Reagan administration actually succeeded in rescinding some of the fiscal 1981 budget, so that if we use calendar years, both 1981 and 1982 registered falls in absolute spending.\(^72\) In his 1982 State of the Union address, President Reagan proposed a readjustment in federal and state responsibilities. He proposed that AFDC and Food Stamps become the responsibility of the states; in return, the federal government would assume full responsibility for Medicaid.\(^73\) Though he found little support for this proposal (called “The New Federalism”), it represented an important element in the view that the appropriate level of government to collect taxes and spend them is that level which is closest to the people. If the benefits of the provision of social goods and services, such as police departments, fire departments, schools, regional transportation systems, and so forth are accruing to people living in close proximity to each other in localities, counties, or, in some case, states, it makes no sense for taxpayers in faraway states to be subsidizing some of that expenditure through federal grants.

In addition, the administration suspected that federal grants had

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In addition, the administration suspected that federal grants had

### TABLE 7. Estimated Outlay Changes in Entitlements without Means Tests Resulting from Reagan Administration Proposals and Congressional Actions through Fiscal Year 1984

<table>
<thead>
<tr>
<th>Program</th>
<th>Projected Outlays under pre-Reagan Baseline</th>
<th>Proposed Changes (% of Baseline)</th>
<th>Enacted Changes (% of Baseline)</th>
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<tr>
<td>Social Security</td>
<td>200.6</td>
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<td>Unemployment</td>
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</table>


\(^{a}\)In billions of dollars.
created “artificial inducements . . . forc[ing] upon the public more spending than it wants to support.” In this view, with a cutback in federal aid, states and localities would tax their citizens only for expenditures their citizens really desired. The argument against such an approach is based on the different income levels in the states. Some states with relatively low tax effort (measured as the percentage of state income paid in state and local taxes) could finance quite high levels of spending, while other states with quite high, burdensome tax effort might, because of low incomes, produce inadequate levels of spending. Why should the per pupil expenditure on education in, say, West Virginia be lower than the amount spent in, say, Massachusetts, even though the percentage of income paid in taxes to West Virginia localities is higher than to Massachusetts localities? Because of concerns such as these, state and local officials rejected the Reagan administration’s proposals, and the “New Federalism” got nowhere in Congress.

Interestingly enough, over a decade later, the Contract with America called for transfer of many federal programs to the states. In the 1990s, many state governors became anxious to be freed from federal red tape and controls in the administration of such programs as AFDC. The proposals that were developed in Congress in 1995 were to replace detailed federal controls with block grants. In return for giving the states more freedom to set rules, the federal government would reduce the amount of money they send to the states and freeze that spending over time. Early controversy in 1995 centered around the food stamps program (which the Contract with America promised to return to the states but which Congress chose to keep under federal control) and the Federal School Lunch Program. It is important to note that the crucial issue in determining whether the state or the federal government ought to finance and/or control this or that program is whether its benefits are national in scope. A local sewage treatment facility benefits people in the immediate region. But can an antipoverty program be considered of only local concern?

To return to the effort to shrink the federal government, such a contraction did not occur because the increase in defense spending that had begun under Carter was accelerated by the Reagan administration (see table 8). Defense purchases had actually declined in real terms until 1976. After that decline was reversed, defense purchases continued to decline as a percentage of GDP through 1979. However, the last two Carter budgets, 1980 and 1981, provided for increases in defense spending above the growth in GDP. The first two Reagan budgets con-
continued that trend. In 1984, because GDP grew so rapidly, the percentage spent on national defense fell (from 6.1 to 6.0 percent), but then it resumed its upward trend until it peaked in 1986 at 6.2 percent of GDP.

This increase in defense spending made it impossible to shrink the size of government, despite initial success with domestic spending in the first Reagan budget. Thus, in the end the tax cuts were never matched by spending reductions. This has produced a long political as well as analytical battle between those who blame the high deficits and resulting expansion of the national debt on the tax cuts and those who emphasize the failure of Congress to get spending under control. Whatever the cause, there is no dispute that even after the recovery from the 1981–82 recession the federal budget ran in the red to an unprecedented extent, except for periods of major wars.

### Reagan’s Successes: A Summary

The period from 1981 to 1984 was the high-water mark of the Reagan Revolution. By supporting the stringent anti-inflationary policy of

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<table>
<thead>
<tr>
<th>Year</th>
<th>Defense Spending (billions of dollars)</th>
<th>Defense Spending (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>86.5</td>
<td>5.6</td>
</tr>
<tr>
<td>1976</td>
<td>89.6</td>
<td>5.2</td>
</tr>
<tr>
<td>1977</td>
<td>97.2</td>
<td>4.9</td>
</tr>
<tr>
<td>1978</td>
<td>104.5</td>
<td>4.9</td>
</tr>
<tr>
<td>1979</td>
<td>116.3</td>
<td>4.7</td>
</tr>
<tr>
<td>1980</td>
<td>134.0</td>
<td>4.9</td>
</tr>
<tr>
<td>1981</td>
<td>157.5</td>
<td>5.2</td>
</tr>
<tr>
<td>1982</td>
<td>185.3</td>
<td>5.8</td>
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<tr>
<td>1983</td>
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<td>6.1</td>
</tr>
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<td>1984</td>
<td>227.4</td>
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<tr>
<td>1985</td>
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<tr>
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<td>273.4</td>
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<tr>
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<td>282.0</td>
<td>6.1</td>
</tr>
<tr>
<td>1988</td>
<td>290.4</td>
<td>5.9</td>
</tr>
</tbody>
</table>


*Note: Data is for fiscal years. Fiscal 1975 and 1976 ran from July 1 to June 30. After a transitional third quarter in 1977, fiscal 1977 and subsequent fiscal years have run from October 1 to September 30.*
the Volcker Federal Reserve Board, Reagan had in effect acquiesced in whatever recession would be necessary to cut inflation. The Economic Recovery Tax Act significantly curtailed the level and growth of the federal government’s income tax revenue. There was a significant reduction in the nondefense, nonentitlement part of the budget, masked by rises in defense spending. Reagan’s more dramatic actions included various regulatory reforms, the attempts as well as the achievements. There is no question that the climate in Washington relating to the role of the federal government in our nation’s economy had begun to change. From the point of view of those who adhered to the conservative diagnosis of what had ailed the economy, it truly was, in the words of the 1984 Reagan campaign slogan, “Morning in America.”