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GOVERNMENT SPENDING AND BUDGET DEFICITS IN THE 1980s: A PERSONAL VIEW

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ABSTRACT

This paper, which was written as part of the NBER project on American economic policy in the 1980s, examines the changes in government spending and budget deficits during the decade. The paper analyzes why the deficit increased substantially and looks at the policy options for reducing the deficit that were considered. The paper discusses the period when the author was a member of the Administration in greater detail than other years in the 1980s and seeks to explain why the policy choices evolved as they did.

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Government Spending and Budget Deficits in the 1980s: A Personal View

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This paper is part of a longer essay on American economic policy in the 1980s. The other parts of that essay appear as three NBER working papers that deal with: monetary policy; tax policy; and the dollar and international trade.

These essays are not intended as a detailed history of economic policy during the decade. Excellent analytic histories have been written by others as part of the NBER project on American Economic Policy in the 1980s. The study of government spending and budget policy for that forthcoming book was written by James Poterba. A related chapter dealing with economic policy toward the aged was written by David Wise and Richard Woodbury.

My own essays are an attempt to analyze some of the reasons for the policy changes that occurred in the decade and to offer my judgements about some of those changes. I have therefore not commented on the papers by Poterba, Wise and Woodbury or other published discussions of budget policy during this period. I do provide some bibliographic references to my own papers, particularly nontechnical ones, in order to incorporate them into this paper.

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The budget deficit was the primary problem that concerned me during my two years as CEA chairman (from mid-1982 to mid-1984) and was a continuing source of controversy with some other members of the Reagan Administration. Even now, a decade later, the

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deficit remains a major problem that I would regard as the significant negative legacy of a decade of otherwise generally favorable policy developments.

Long before the 1980 presidential campaign Ronald Reagan had been an advocate of reducing both taxes and nondefense spending. Both of these goals were achieved to a surprising and unprecedented extent during the first two years of the Reagan presidency. The tax cuts turned out to be much greater than expected while the spending cuts were much less than the President and his advisors had anticipated. The result was an enormous budget deficit that continues until the present.

The failure to correct the deficit reflects a complex mix of personal, political and economic factors. Before trying to unravel them, I begin with a brief overview of the changes that occurred in the pattern of government spending. I then discuss the role of economic analysis in shaping the changes in the components of government spending. After that I look in detail at two aspects of budget policy that were important during my years in Washington: Social Security reform and the attempted reform of Medicare and the tax treatment of health insurance. Finally, I discuss the budget deficit itself: its origins, the attempts to control it, and the reasons why it remains unresolved.

1. The Changing Structure of Government Spending

The broad structure of federal government spending changed dramatically during the 1960s and 1970s. The share devoted to defense fell rapidly while nondefense spending rose

even faster. These trends were halted and reversed in the 1980s. Table 1 presents the components of government outlays as percentages of gross domestic product.[2]

Spending for defense (including other international programs) fell from 10.5 percent of GDP in 1962 (a time before the increase in military spending associated with the Vietnam war) to 5.6 percent in 1980. This sharp decline was halted in the 1980s. A substantial investment in defense equipment and a significant rise in military pay raised the defense share of GDP during the first half of the decade to 6.9 percent of GDP in 1986 before it declined again to 5.8 percent of GDP in 1990.

Outlays on the Social Security and Medicare programs for the aged, together with other retirement and disability programs, more than doubled as a share of GDP from 3.0 percent in 1962 to 6.9 percent in 1980. The rapid growth continued during the first two years of the Reagan administration (to 7.8 percent of GDP in 1982) but then declined and stabilized at 7.6 percent of GDP as the very fast real GDP growth during the recovery outstripped the rise in Social Security spending by enough to offset the increases in Medicare costs.

The third major change in the structure of spending, and in many ways the most dramatic, was the sharp reversal of the rise in other nondefense outlays. Total domestic spending, other than the Social Security and related programs (shown in row 3 of Table 1) rose from 4.5 percent of GDP in 1962 to 7.9 percent in 1980. By 1984, it had been cut from

[2] The figures begin with 1962 because that is the first year for which the Congressional Budget Office provides comparable data.

Table 1

Government Outlays as a Percentage of GDP

		1962	1970	1980	1982	1984	1985	1990
1.	Defense and International	10.5	8.7	5.6	6.4	6.6	6.8	5.8
2.	Social Security, Medicare and Related Retirement	3.0	4.4	6.9	7.8	7.6	7.6	7.6
3.	Other Domestic Spending	4.5	5.2	7.9	6.9	5.9	6.1	6.1
	(3a) Domestic Discretionary	3.0	3.9	4.9	4.1	3.7	3.7	3.3
	(3b) Entitlements excluding Social Security, Medicare, Related Retirement	2.8	2.6	4.1	4.1	3.4	3.7	2.8
	(3c) Offsetting Receipts	-1.2	-1.2	-1.1	-1.2	-1.2	-1.2	-1.1
	(3d) Deposit Insurance	-0.1	-0.1	0	-0.1	0	-0.1	1.1
4.	Net Interest	1.2	1.5	2.0	2.7	3.0	3.3	3.4
5.	Total	19.3	19.9	22.3	23.9	23.0	23.8	22.9
6.	Total without Deposit Insurance	19.4	20.0	22.3	24.0	23.0	23.9	21.8

Source: Congressional Budget Office

Totals may not equal the sum of individual components because of rounding errors.

7.9 percent to 5.9 percent, a fall of more than one-fourth in the GDP share. It is of course always hard to know what would have happened without the determined effort of the Reagan administration to cut such spending. But if spending had continued to grow relative to GDP during the 1980s as it had in the previous two decades, it would have reached 10.8 percent of GDP in 1990. The gap between that hypothetical projection and the actual 6.1 percent spending level represented more than $260 billion a year of outlays.

Despite the fall in total domestic spending relative to GDP, total government outlays relative to GDP showed little change in the 1980s. During the first half of the decade, this was due in equal measure to the rise in defense spending and in net interest payments. For the decade as a whole, the defense increase was only 0.2 percent of GDP. Social Security and related programs rose much more rapidly, increasing by 0.7 percent of GDP. Together these offset half of the 1.8 percent fall in Other Domestic Spending, leaving a net decline in spending of only 0.9 percent of GDP. However, the rise in net interest costs from 2.0 percent of GDP to 3.4 percent caused total government outlays to rise from 22.3 percent of GDP in 1980 to 22.9 percent in 1990.

These figures are somewhat misleading because of the large outlay for deposit insurance in 1990 (equal to 1.1 percent of GDP) after the deposit insurance program showed small surpluses over the previous decade. A more appropriate analysis would exclude deposit insurance outlays since these represent only the explicit recognition of losses that had accrued over a period of years.[3] When deposit insurance is excluded, the category "Other

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[3] That procedure is followed by the Congressional Budget Office in many of their analytic comparisons. A further reason for excluding deposit insurance outlays is that some of those outlays are for the purchase of assets that will later be sold. See

Domestic Spending" declines from 7.9 percent of GDP in 1980 to 5.0 percent of GDP in 1990. Because of the 0.2 percent of GDP rise in defense spending and the 0.7 percent of GDP rise in Social Ssecurity and related programs, total non-interest spending was down 2.0 percent of GDP. Even after the 1.4 percent of GDP rise in net interest payments, total government spending was down by 0.5 percent of GDP.

Nevertheless, for many conservatives, the attempt to shrink government spending had failed. This hardened their opposition to tax increases to deal with the budget deficit. But within the increased total outlays, there had been a dramatic and unprecedented reduction in domestic spending. The conservatives had achieved a greater budget victory than anyone could have anticipated in 1980. But because many conservatives refused to recognize their own political success, they were not prepared to adjust the revenue side of the budget to shrink the deficit.

Before looking at the budget deficit debates in more detail, I will examine the impact of economists on the character of the spending changes that did occur.

2. The Role of Economic Analysis in Spending Reforms

2.1 *Defense*

Economic analysis and economists had little influence on the overall level of defense spending. I cannot judge to what extent economists and defense analysts who criticized particular weapons systems did affect the shape of the defense budget. But the overall level of defense spending was not the result of adding up a series of individual decisions. The Administration's target level for total defense spending was decided by the President and

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Feldstein (1989).

Defense Secretary Casper Weinberger and then negotiated with the Congress in similarly aggregate terms.

The national mood at the beginning of the 1980s favored increased defense spending. American military power and influence appeared to be eroding around the globe. The embarrassing failure of the attempted rescue of American hostages in Iran (when the military equipment failed in the desert and the entire mission had to be abandoned) was a symbol of declining capability. There was also a sense that the end of the draft and the erosion of military pay had led to a decline in the quality and morale of the armed forces.

In 1980 President Carter and candidate Reagan both promised that they would raise defense spending if elected for the next four years. During the last two years of his presidency, Jimmy Carter had actually increased defense outlays significantly, from $126 billion in fiscal year 1979 to $172 billion in fiscal year 1981. Even allowing for an approximately 23 percent rise in the price level during this time, real defense spending rose by 11 percent from 5.2 percent of GDP to 5.8 percent of GDP. President Reagan accelerated the increase in defense spending in order to put pressure on the Soviets, to enhance U.S. military capability, and to increase the morale and quality of the services through higher pay.

Cap Weinberger, himself a former OMB director, was able to keep defense spending outside the regular budget process. Although the OMB reviewed the details of the defense budget, the overall level of defense spending was decided by the President and the Defense Secretary alone, something without parallel in the other spending departments and a continuing source of frustration to OMB Director David Stockman.

After 1983, Congress tried to reduce the budget deficit by cutting the growth of defense spending. There was a growing public debate about whether the amount of defense spending requested by the Administration was justified and about whether the rise in defense outlays was responsible for the budget deficit.

When I was CEA chairman, I recognized that as an economist I didn't have the expertise to judge the proper amount of defense spending. My view, which I repeatedly said publicly, was that the nation could certainly afford the current and projected levels of defense spending if we were willing to pay for them by raising taxes or cutting other spending. Privately I tried unsuccessfully to enlist Weinberger as an ally in the internal debate over raising taxes. I argued to him that without higher taxes Congress would cut the Administration's defense requests more sharply than if there were the additional revenue to pay for the increased defense outlays. The President continued to ask for large spending increase for defense but eventually accepted Congress's demand for smaller increases rather than accede to larger tax rises.

2.2 *Domestic Discretionary Spending and Entitlements other than Social Security and Medicare*

In contrast to the negligible role that economics played in shaping the size and composition of the defense budget, economic analysis did have a substantial impact on the myriad of annually appropriated nondefense programs (the so-called domestic discretionary budget) and the smaller "entitlement" programs other than Social Security, Medicare and related retirement programs. Although the economics profession as a whole pays relatively little attention to most of these programs, those economists who had studied them were often critical of individual programs. They criticized them for having costs that exceeded the

resulting benefits, for transferring to the government things that could be better done in the private sector, and for creating adverse incentives for individuals and businesses. Such programs would have been worth cutting or eliminating even if there were not a large budget deficit.

Economists were generally not involved in the detailed legislative process dealing with these spending programs but there is no doubt that economic reasoning set the framework for selecting appropriate spending cuts. Specific program cuts generally originated in the OMB. David Stockman was not only a brilliant budget director but also a "natural" economist who instinctively focused on programs that an economist would identify as suitable for cutting.[4] The budget ax fell heavily on such things as the Carter energy program, on transfer programs that created adverse work incentives, on wasteful intergovernmental grants, and similar activities.

Table 1 shows that between 1980 and 1984 the combination of nondefense discretionary spending and the group of smaller entitlement programs was reduced from 9.0 percent of GDP to 7.1 percent of GDP, a drop of more than one-fifth of the former GDP share. Although some of the initial 1981 spending cuts were eventually restored, the decade ended with these programs down to only 6.1 percent of GDP. In contrast to this 32 percent decline in the GDP share in the 1980s, the corresponding spending share of GDP had risen by more than 12 percent in the 1960s and by 38 percent in the 1970s. David Stockman is

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[4] Describing Stockman as a "natural" economist may be misleading. When I met Stockman at the beginning of his first year in Congress, he had done some systematic reading of economics and continued to read nontechnical economics during his years in Congress.

undoubtedly too modest in his comment in the American Economic Policy in the 1980s that he and President Reagan had done little to reduce domestic spending. Two things are striking about these cuts in nondefense discretionary spending. First, the major spending cuts were largely enacted during the first legislative year after President Reagan's inauguration.[5] Second, the political power of the aged allowed them to avoid cuts in the programs that specifically benefitted them. Instead the cuts fell primarily on small programs with changing groups of beneficiaries like unemployment insurance.

2.3 *Net Interest Costs*

Interest payments on the national debt increased from 2.0 percent of GDP in 1980 to 3.4 percent in 1990. The primary driving force in this increase was the growth of the national debt that resulted from the large budget deficits. The increase in the debt held by the public, from 26.8 percent of GDP in 1980 to 44.2 percent in 1990, accounts for nearly all of the rise in the interest outlays.

Although the net interest payments on the government debt were a large and rising component of total government outlays in the 1980s, the Treasury department failed to accept economic advice on how that debt service cost could be reduced. Throughout the decade, the Administration issued forecasts that inflation and interest rates would continue to decline. These forecasts were sincerely believed and turned out to be correct. The Treasury

[5] This reflected not only the substantial size of the early successes but also the loss of the effective control of the House of Representatives that occurred after the 1982 election. Although the Republicans were a minority in the House in 1981 and 1982, the coalition of Republicans and conservative Democrats supported the Reagan spending reforms. The Republicans suffered substantial losses in the 1982 Congressional election because of the recession and the abortive attempt at cutting Social Security benefits (discussed below).

nevertheless failed to accept the logic of their own forecasts by borrowing short in anticipation of the declining rates. Instead, the Treasury actually lengthened the maturity of the debt.

The national debt might however have been managed in a way that significantly reduced the government's interest cost. Although interest rates were higher at the start of the decade than they had been in the 1970s, the level of interest rates then fell sharply throughout the decade. The interest rate on ten year bonds fell from 13.9 percent in 1981 to 7.7 percent in 1986 and then remained under 9 percent for the rest of the decade. Shorter term rates fell even faster. The yield on a three year Treasury security fell from 14.4 percent in 1981 to 7.1 percent in 1986 and then stayed below nine percent.

In 1983, when the interest rates on 10 year bonds was still over 10 percent and the Administration was forecasting a sharp fall in rates over the next five years, I suggested that the Treasury either borrow short (with the prospect of lengthening later when rates had declined), or use a floating rate note, or link the interest rate to the rate of inflation.

Such suggestions were rejected by Treasury Secretary Don Regan for reasons that I could never understand. He argued, for example, that indexing the interest rate to inflation would indicate that we had lost confidence in our ability to reduce inflation in the future. I explained (to no avail) that the opposite was true. While the unwillingness of financial markets to lend to a government on a long-term fixed rate basis is evidence that the market lacks confidence in that government's ability to control inflation, the United States was clearly able to issue long term debt. Our decision to borrow with an interest rate that was

linked to inflation or to Treasury bill rates would show our confidence that rates would decline in the future.

But debt management is quite definitely a Treasury responsibility and the CEA can only offer friendly advice. The Treasury not only failed to respond to its own interest rate forecasts but instead continued a policy, begun under the Carter administration, of deliberately lengthening the maturity of the debt. The average length of the privately held public debt rose from three years and nine months in 1980 to over six years in 1990.

3. Social Security Reform

The Social Security reforms enacted in 1983 were among the most remarkable domestic policy developments of the decade, not only in the magnitude of the changes that were made but also in the procedure that was followed and in the incongruity of the reforms with the basic philosophical position of the president.

When I joined the Administration in 1982 I had been studying Social Security for more than 15 years since my days as a graduate student. I was (and remain) convinced that the provision of high Social Security benefits substantially reduces private saving and is a significant cause of our low national saving rate (Feldstein 1974a and 1985).

Social Security was on the administration's agenda from the start for two reasons. Such a large program (it represented 4.4 percent of GDP in 1980) could not be ignored in any attempt to reduce total government spending. Moreover, the Social Security program was itself in financial trouble with payroll taxes too low to cover current or projected benefits. The trust fund was shrinking and would soon be depleted unless some action was

taken. This problem provided the opportunity for a serious consideration of Social Security reform.

The Administration's original 1981 budget plan, in addition to containing detailed proposals for changing taxes and spending, identified one major deficit reduction only by a set of asterisks and a promise that more detail would be given later. These asterisks actually denoted a major reduction in projected Social Security outlays which the Administration had not yet designed in detail.

The President had been advocating a reduction of Social Security benefits for at least a decade. He objected to the payment of benefits to older individuals with high incomes and thought it wrong to have such high payroll taxes for a system not based on need. But he had gotten into political trouble himself once in proposing a change in Social Security in the 1976 presidential election primaries. He therefore instructed the OMB in 1981 to design a reduction of Social Security outlays without actually cutting benefits to anyone 65 years old or older. Such a constraint need not have interfered with a long-term strategy for slowing the growth of Social Security, especially if the President's restriction could be interpreted to refer to nominal dollars so that a modification of the full benefit indexation was acceptable. But the need for substantial short-term budget cuts and for an immediate remedy of the Social Security program's financial problem caused OMB to formulate a short-term plan that satisfied the President's specific injunction against cutting benefits of those over age 65 but violated its spirit by proposing sharp benefit reductions for retirees between the ages of 62 and 64. The OMB proposal called for an immediate and very substantial (20 percent) cut in

the benefits of anyone who took early retirement at age 62 with pro rata reductions for those who retired between the ages of 62 and 65.

The proposal for an abrupt reduction in benefits of individuals who were expecting to retire very soon caused a political uproar. The members of Congress were so opposed to the idea that none of them was prepared to introduce the Administration's plan. Indeed, the Senate soon passed a unanimous sense-of-the-Senate motion putting themselves on record as opposed to any substantial cut in benefits.

A similar political fiasco occurred over the Administration's plan to eliminate the floor on Social Security benefits.[6] Although the minimum benefit recipient conjures up the image of an individual with very low income, many of the minimum benefit recipients are retired government workers with substantial pensions who qualified for the minimum Social Security benefit by working in private industry for a few years after leaving government employment.[7] Retirees who have very low Social Security benefits and no other income are entitled to means-tested Supplemental Security Income benefits. Nevertheless, the proposal to eliminate the minimum benefit was easily misinterpreted by its opponents and used to criticize the Reagan administration for denying Social Security to "the most needy"

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[6] Social Security benefits are based on a formula that provides that the level of benefits at retirement is a function of the inflation-adjusted average monthly earnings during the individual's working life with a variety of adjustments to eliminate anomalous years. If this calculation results in a benefit below a prescribed minimum, the law provides that the individual will receive the minimum benefit.

[7] Federal employees did not at that time participate in Social Security but could qualify for benefits by working in private employment before or after the years with the government.

beneficiaries. The legislation repealing the minimum benefit was subsequently reversed by the Congress.

As a result of these two misjudged proposals, the Democrats were able to attack Congressional Republicans who were running for reelection in 1982 as opponents of Social Security and of the aged. The Republicans eventually suffered substantial election defeats and lost effective control of the House of Representatives. The memory of those losses deterred Congressional Republicans from supporting modifications of Social Security in future years.

Nevertheless, the financial gap in Social Security funding remained and had to be addressed. In an attempt to limit the damage to Republicans in the 1982 election, the President proposed that a solution to the financial problems of Social Security be worked out by a bipartisan committee headed by former CEA Chairman Alan Greenspan with members appointed by himself and by the Republican and Democratic Congressional leaders. The Committee would report in December 1982, after the election. The proposal was supported by the Congressional leadership of both parties.

During the months before the election, the Greenspan Commission did work separately from the White House and other parts of the Administration. There were however private discussions among the Administration senior staff and with the President. In these private discussions, the President stressed his desire to see the financial problems of the Social Security program resolved by reducing the growth of future Social Security benefits. He recalled that the program began with a promise that the combined tax rate would never exceed two percent and he resented the pressure to raise taxes from the existing 13.4 percent

level. He wondered why the Social Security program could not be privatized and reluctantly accepted the explanation that continuation of the existing Social Security payroll taxes was needed to finance benefits of the current retirees.

Dave Stockman and I analyzed and discussed possible Social Security reforms. I favored a change in the indexing of Social Security benefits, shifting from the existing law that maintains post-retirement benefits constant in real terms to indexing benefits by three percent less than the inflation rate. A three percent threshold would still protect beneficiaries fully from any increase in the inflation rate above three percent. Limiting the index modification to five years would mean that no individual's real benefit would be cut by more than 15 percent. The lowest 25 percent of benefits could be exempted from the adjustment without significantly altering the prospective savings. Stockman, who also wanted to shrink Social Security, focused on more opaque options like changing the "bend points" in the Social Security formula (i.e., the income levels at which the ratio of benefits to past earnings changes.)

In December 1982, the Greenspan Commission announced that it was at a stalemate with Democrat and Republican members sharply divided on what should be done. The Democrats were unwilling to reduce benefits or postpone the retirement date. The Republican members didn't want to close the Social Security financing gap by tax increases alone. But without a unanimous report, Social Security would be thrown back into partisan controversy.

James Baker, then White House Chief of Staff, was having active discussions with Commission member Alexander Trowbridge, a Democratic appointee, former Commerce

Department Secretary, and current head of the National Association of Manufacturers. It was never clear to me why Trowbridge was negotiating contact with the Commission. Baker reported to the White House Social Security group[8] the "compromise" that Trowbridge suggested for closing the Social Security financing gap: advance the date of a future payroll tax increase that had been enacted during the Carter years; subject half of the Social Security benefits of married recipients with incomes over $32,000 and single recipients with incomes over $25,000 to personal income taxation (with the resulting revenue transferred from the Treasury to the Social Security trust fund); require all employees of nonprofit institutions and new employees of state and local governments to participate in the Social Security program. There would be no reduction in benefits or postponement of the retirement age.

The President was clearly very unhappy with the proposed "compromise." The Administration's group monitoring the Social Security issue discussed the option of encouraging the Republican members to remain firm. There would then be no Commission plan and the Administration could propose a solution to the Social Security financial crisis that was more in keeping with the President's preferences.

I supported this strategy and advocated a change in benefit indexing as a way of achieving substantial outlay reduction over time without actually "reducing any checks in the mail," i.e., without actually causing a decline in any individual's monthly Social Security

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[8] The group that met with the President and Vice-President to discuss these issues was David Stockman, Don Regan, White House Domestic Policy Adviser Ed Harper, Jim Baker, Presidential Counselor Ed Meese, Dick Darman (Jim Baker's deputy), Cabinet Secretary Craig Fuller, Legislative Affairs Director Ken Duberstein, Communications Director David Gergen and myself.

check. I knew that the public opinion polls being conducted by the Chamber of Commerce and by the President's pollster (Dick Wirthlin) showed that the public favored limiting Social Security indexing to the same partial rules that prevailed in private industry. I described this to the President and made the case for a three percent threshold on benefit indexing.

The President talked about going on television, explaining to the viewers that high income individuals shouldn't be getting Social Security benefits from the government and that most retirees were getting much more in benefits that they had paid for. The only way to avoid higher taxes for younger families was to slow the growth of benefits. It looked for a while like the combination of a Social Security financing crisis and a conservative President would bring about the reduction in the size of the Social Security program that I thought was desirable for quite different reasons.

But as the discussion continued, Jim Baker argued that that was too dangerous a strategy politically and that it would cause Republicans as a party to be stigmatized as opposed to Social Security and to the aged. He argued that even if the polls currently implied that the public would support the President's ideas, that support would not persist after the Democrats mounted a campaign against the proposed changes. In any case, Baker argued, the Republicans in Congress had been hurt in the 1982 elections by the Administration's Social Security proposals and would not support any proposal that could be characterized as a plan to shrink Social Security.

Although as a general rule, I didn't get involved in Congressional negotiations, in this case I wanted to see for myself how much potential support the President would have if he proposed to modify Social Security indexing or some other aspect of Social Security benefits.

My visits with Congressional Republicans were not encouraging. While most of them spoke about the desirability of limiting benefit growth rather than raising taxes, almost every one of them explained why in his own particular case it would be much easier to vote for a bipartisan plan to raise payroll taxes than to support a controversial Presidential initiative to slow benefit growth. The benefits of reducing the relative size of Social Security and thereby avoiding a two percentage point increase in the payroll tax seemed too small and the cost to Republicans of reducing Social Security benefits -- even if only the growth of those benefits -- was politically too high for them to take on what would become a partisan issue.

What would have happened if the President had decided to "go to the people" will never be known. He decided to follow Jim Baker's advice to accept a compromise plan proposed by the Greenspan Commission's Democrats. He indicated some modifications that he wanted and said that he would encourage the Republican members of the Commission to accept the modified plan. He rationalized that the payroll tax increase was really just an advancing of the date of a tax increase that had been proposed by President Carter and therefore not really "his" tax increase. Similarly, he accepted the interpretation that subjecting half of the benefits of the higher income aged to the income tax was really equivalent to a reduction of benefits (ignoring the fact that it would be a reduction related to taxable income and therefore similar to a tax increase on higher income taxpayers. Although not indexing the income level at which such taxing begins would eventually make this a virtually universal tax, it would still be a greater tax on individuals in higher tax brackets.) Expanding Social Security to currently uncovered workers could be regarded as closing an existing loophole.

Although the size of Social Security was not reduced, Social Security rules were changed in several ways that economists had long advocated to reduce the distortion in retirement behavior. First, the reduction of benefits for "retirees" with earnings above a threshold amount was reduced from 50 cents per dollar of extra earnings to 33 cents. Second, the increase in benefits for those who delayed retirement beyond age 65 was raised and scheduled to go on rising for future retirees until eventually the benefits would be actuarially equal regardless of the age of retirement. Finally, although the Commission did not have the political courage to raise the retirement age, the Congress did modify the Commission's proposal and enact a postponement of the retirement age at which full benefits would be payable from 65 to 67 in the next century.

With these changes in taxes and future benefits, the Social Security actuaries could project that the system would remain solvent for the 75 year Social Security forecast period. There would be a substantial Social Security surplus for several decades. This surplus would permit a fund to accumulate that could be used to meet the rising benefit obligation that would occur as the baby-boom generation retired after 2020 without increasing the payroll tax rate at that time. Surprisingly, this feature of the reform received relatively little attention in our discussions which focused instead on the implications of the reforms for the Social Security finances in the 1980s and for the next few years of budget figures.

The Social Security reforms of the 1980s were one of the great ironies of the Reagan administration. Here was a President who wanted a substantial reduction in Social Security benefits. His OMB Director and CEA Chairman were also eager for such reductions. A substantial deficit in the Social Security program had forced a consideration of future benefits

and taxes. And yet, when the dust settled, the Social Security program had not been reduced but had actually been given a more secure future. The 1983 legislative changes in Social Security thus removed the pressure for immediate benefit reductions, helped to maintain confidence in the future benefit payments, and reduced the prospects of a substantial future benefit reform induced by a subsequent financial crisis as the total cost of benefits increased. The tax increases enacted in 1983 meant that for the next 75 years it would not be necessary to increase taxes again to meet the obligations that would result from the increased number of retirees. The size of the Social Security program was significantly enlarged by extending mandatory coverage to all employees of non-profit institutions and eventually to all state and local government employees. The financing barrier between the proportional payroll tax earmarked for Social Security and the graduated personal income tax was broken by transferring funds from general revenue to the Social Security trust fund.

4. Reforming Medicare and the Health Insurance Tax Rules

In the 15 years after it began, the Medicare program of health care for the aged grew from $3.2 billion in 1967 to $49 billion in 1982. Unlike Medicaid, which is means tested and financed in part by the individual state governments, Medicare is a program for all of the aged and it is fully financed by the federal government.

Health care was another area that I had been thinking about since my student days. By the early 1980s, experts agreed that Medicare's existing system of comprehensive insurance and cost-plus hospital reimbursements was a major contributor to the explosive rise in the cost of the Medicare program and more generally to the national rise in health care costs. My own research over the years had convinced me that greater out-of-pocket

payments by patients at the time of care (i.e., increased deductibles and coinsurance) would make patients and their doctors more cost-conscious and would thus improve the allocation of health care resources and reduce the excessive rise in health care costs.[9] I was also convinced (and remain convinced) that the exclusion of employer health insurance payments from taxable income caused health insurance to be much more complete and to have less cost-sharing by patients at the time of care than would have been true without the implicit tax subsidy (Feldstein, 1973; Feldstein and Allison, 1974; Feldstein and Friedman, 1977).

I was pleased therefore that the desire to limit the increase in Medicare costs and the search for ways to increase tax revenue by "closing loopholes" put health care reform on the agenda as we prepared the budget to be submitted in February 1984.

The basic tax reform idea was to limit the employers' ability to provide tax-free income in the form of health insurance premiums. Political reality precluded including all employer-provided health benefits in taxable income. At most, the amount of tax free income could be limited either by including in the employee's taxable income any employer payments over a certain level or by denying firms the usual business expense deduction for insurance premiums above a certain level. Either option would provide the correct incentive at the margin for employees with high levels of employer-provided health benefits. Indexing the taxfree limit to the general level of consumer prices would cause it to rise more slowly than medical care costs and therefore to become more significant over time.

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[9] Several of my papers dealing with health insurance and hospital costs are collected in Feldstein (1981a).

The proposed change in the tax rule was described publicly as a way of raising tax revenue by closing a tax loophole that disproportionately favored high income taxpayers. The idea that it would change the character of health insurance and therefore the patterns of health care was considered better left unsaid.

A parallel change was discussed for Medicare with an emphasis on increasing various deductibles and coinsurance payments to be paid by patients at the time that care is received. I favored this as a way of improving incentives in the choices of medical care. The budgeteers at OMB thought it would be a good idea even if there were no behavioral response since it would reduce the cost of the Medicare program.

These tax changes and Medicare reforms were proposed by the President but died in the Congress. In retrospect, I believe that we set the limits on tax-free insurance premiums too low. Since many union contracts provided for benefits above the allowable level, the unions strongly opposed the proposed change on the basis of their members' immediate interests as well as on more general philosophical grounds. Similarly, too many Medicare recipients would see significant increases in their out of pocket costs. It would have been better to establish the principal of limiting the tax subsidy by setting much higher limits for tax-free employer payments and permitting the rise in medical care costs to make the limit binding for an increasing number of individuals over time. Similarly it would have been better to introduce coinsurance payments at much higher levels of Medicare benefits and allow general medical care inflation to make these more broadly applicable over time. Because of the Administration's eagerness for immediate revenue rather than structural

reform, we got neither. In this way, the Medicare experience was very similar to our earlier experience with Social Security reform.

The analysts at the Department of Health and Human Services were developing a different approach to Medicare reform. The HHS approach was to replace the existing system of reimbursing hospital costs with a system of paying specific fixed prices for patients in each of several hundred individual diagnostic groups. The HHS officials argued in interagency meetings that this would make the purchase of hospital care by the Medicare program similar to the market system by which the government procured other goods and services: setting a price and buying from vendors who would sell at that price. I argued unsuccessfully that this analogy was faulty because paying for the treatment of a patient with a particular diagnosis was very different from buying ordinary products and service. I was never certain whether the HHS officials really believed in the "market system" analogy of the proposed payment system or just regarded that as a useful way to sell their cost regulation plan to a market-oriented administration.

Although I liked the idea of ending the traditional cost-plus approach to reimbursing hospitals, I worried that the proposed HHS system would create an extensive bureaucracy to check that patients were correctly classified, to monitor the patients that were admitted to hospitals (to reduce unwarranted admissions), and to make certain that patients were not "undertreated" in order to keep costs down. It seemed ironic that a strongly market-oriented administration would not strengthen the market mechanism in medical care (by introducing copayments or competition among group providers) but should instead accept government price setting and detailed bureaucratic supervision for its largest domestic procurement.

5. Budget Deficits

Although the federal budget has been in deficit in all but nine years in the past half century, the deficit soared to new heights in the 1980s. These deficits absorbed more than half of net domestic saving, putting upward pressure on real interest rates and inducing a massive trade deficit in the 1980s.

But unlike inflation and unemployment, the deficit is not visible to the general public and its links to the future performance of the economy remain vague and poorly understood by almost everyone. The traditional association of deficits with inflation was clearly shown to be wrong by the U.S. experience of the 1980s. I regarded it as one of my important tasks to educate not only my Administration colleagues about the long-run adverse effects of budget deficits but also the relevant members of Congress and the public at large. Only if they understood the serious long-run effects would they be willing to incur the short-run costs that would be needed to reduce the deficit.

Looking back on the decade of the 1980s, too little was done to cut the deficit and to restrain its future growth. The political costs of deficit reduction clearly and understandably exceed the political benefits of a smaller deficit and a higher national saving rate. That something was done in almost every year to shrink the deficit showed that the President and key Congressional leaders did care about the problem. That more was not done showed that they did not care enough.

5.1 *Sources of the Increased Deficit*

In fiscal year 1984, more than a year after the start of a strong economic recovery, the deficit had reached 5.0 percent of GDP. The sharply rising deficit had generated a

debate about its sources that sought to place blame and to justify alternative remedies. The Administration's critics charged that this was due to excessive tax cuts and large increases in defense spending. The Administration responded that much of the deficit was inherited from the Carter administration, that it had been enlarged by the recession, and that the real problem lay in rising entitlement costs and other so-called uncontrollables.

There were enough facts to support almost any conclusion. Debaters could prove almost anything by talking about nominal levels of taxes and spending: "How could tax cuts have caused the deficit since revenues actually rose from $517 billion in 1980 to $666 billion in 1988?" and "Despite the attempts to control domestic spending, nondefense outlays rose from $444 billion in 1980 to $607 billion in 1984; even if Social Security and Medicare outlays are excluded, domestic spending rose by nearly $80 billion."

The only way to make sensible comparisons is to look at ratios to GDP.[10] Between 1980 and 1984, the deficit rose from 2.8 percent of GDP to 5.0 percent of GDP, implying that more than half of the deficit had been there when President Carter left office. The result is similar if we look at the cyclically-adjusted structural deficit. The Congressional Budget Office estimates that the 1984 structural deficit (calculated at a 5.8 percent unemployment rate) was equivalent to 3.6 percent of GDP. Since the corresponding structural deficit for 1980 was 1.8 percent of GDP, half of the structural deficit was inherited from the Carter administration.

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[10] The most recent figures from the Congressional Budget Office (The Economist and Budget Outlook: Fiscal Years 1993-97) now state ratios to GDP and I use these figures even though we were looking at GNP ratios in the 1980s.

The 2.2 percent of GDP rise in the deficit between 1980 and 1984 can, in a purely arithmetic sense, be attributed roughly one-third to higher spending (total outlays rose by 0.6 percent of GDP) and the remaining two-thirds to lower taxes as a share of GDP. But the more one disaggregates the spending and tax totals, the more ambiguous the sources of the deficit become. For example, the "uncontrollable" outlays for Social Security and related programs and for net interest rose by 1.7 percent of GDP over the same four years, accounting for more than three-fourths of the increase in the deficit. Since "Other Domestic Spending" fell relative to GDP by 2 percentage points (from 7.9 percent to 5.9 percent) this was more than enough to offset all of the 1.6 percent of GDP decline in revenue (from 19.6 percent of GDP to 18.0 percent).

The most common view of the 2.2 percent of GDP increase in the deficit between 1980 and 1984 attributed it to a combination of the revenue decline (1.6 percent of GDP) plus the rise in defense outlays (an increase of 1.0 percent of GDP). But to those who made this argument, it could reasonably be replied that the cut in "other domestic spending" paid for more than 75 percent of the combined effect of lower taxes and increased defense outlays.

For the decade of the 1980s as a whole, the combination of the increased defense spending (from 5.6 percent of GDP to 5.8 percent) and the relative decline in revenue (from 19.6 percent of GDP to 18.9 percent) added only 0.9 percent of GDP to the deficit, less than one third of the 2.9 percent of GDP decline of "Other Domestic Spending" (excluding deposit insurance payments). The 2.0 percent of GDP rise of the deficit in the 1980s (0.9 percent if deposit insurance payments are excluded) can be more than accounted for by the

combination of the increase in Social Security and related outlays (an increase of 0.7 percent of GDP) and in interest on the national debt (an increase of 1.4 percent of GDP).

No unambiguous resolution of the "sources of the deficit" is possible because the individual components can be combined in many different ways to support different points of view, each of which is true but incomplete.

5.2 *The 1981 Tax Cuts*

There is no ambiguity, however, about the fact that the tax cut enacted in 1981 provided a much larger decline in revenue than the Administration had expected when that legislation was proposed or passed. The primary reason for this was that inflation declined much more rapidly than had originally been expected. A second but less powerful reason was that real economic growth was lower than projected in 1981. And finally, as Don Fullerton's chapter in American Economic Policy of the 1980s documents, the tax bill that emerged from the Congress was much more generous to business taxpayers than the original Administration proposal.

A calculation that I made in January 1983 for discussion with the President and other members of the budget group[11] shows just how much greater the personal tax cuts were turning out to be than had originally been intended. The Administration's original proposal for a series of three 10 percent cuts in personal tax rates ("10-10-10") was projected in the February 1981 budget calculations to reduce individual income tax collections to 11.3 percent

[11] The small group that met intensively with the President in January to make decisions on all aspects of the budget consisted of Vice-President Bush, the three senior economics officials (Don Regan, Dave Stockman, and myself) and several White House staff members (Ed Harper, Jim Baker, Ed Meese, Dick Darman, Craig Fuller, Ken Duberstein, and Dave Gergen.)

of personal income in 1986. But using the January 1983 economic forecast, individual income tax payments in 1986 would be only 10.1 percent of personal income.

This sharp decline in projected tax revenue was due almost completely to the revised economic outlook, particularly to the lower rate of inflation and therefore the reduced extent to which "bracket creep" would raise real tax liabilities. The extra tax breaks for individual taxpayers that Congress had voted in 1981 were just about offset by the effect of substituting a 5-10-10 schedule of rate cuts for the originally proposed 10-10-10 schedule of rate cuts. Substituting the actual 1981 tax legislation (The Economic Recovery Tax Act) for the proposed 10-10-10 plan but retaining the 1981 economic forecasts only reduced the projected revenue share of personal income from 11.3 percent of personal income to 11.2 percent.

I produced these numbers to support the case for a "mid-course correction," a revision of the third part of the 5-10-10 tax cut or a modification of the inflation indexing of personal tax brackets that had been enacted in 1981 and that was scheduled to begin in 1985. I argued that if the President had been satisfied with the relative tax burden projected in 1981 (i.e., that individual income taxes would equal 11.3 percent of personal income in 1986), a modification of existing tax rules was now necessary to achieve those original targets.

The President was not persuaded by this argument. The original proposal for a 10-10-10 tax cut was not aimed at achieving a particular relative tax burden but at cutting taxes as much as feasible. Viewed from the perspective of 1980, the implied level of taxes hardly represented any decrease at all. The Administration's 1981 projection that 10-10-10 would lower the ratio to 11.3 percent in 1986 was essentially only equivalent to maintaining the current tax share unchanged, not even seeking to return to the tax share of the middle of the

1970s. Individual income tax payments were 11.0 percent of personal income in 1979 and 1980 and 11.5 percent in 1981, up sharply from less than 10 percent of personal income in the mid-1970s.

The key reason for this very small decline in the projected level of individual taxes relative to personal income was the substantial "bracket creep" rise in effective tax rates that was expected to result from the combination of inflation and real income gains in the early 1980s. The February 1981 budget assumed that inflation would decline from over 10 percent in 1980 to 7.7 percent in fiscal year 1982. The actual decline was to less than 5 percent. The forecast also projected strong real GNP growth of 5.2 percent for the coming year. This real growth projection might not have seemed unreasonable for an economy that was just coming out of the 1980 recession and that was then experiencing real GNP growth of more than 6 percent (in the fourth quarter of 1980 and the first quarter of 1981) and still had an unemployment rate of 7.5 percent. You didn't have to believe in supply side miracles to anticipate such real growth, although there were some inside the Administration who were expecting even stronger real growth before CEA Chairman Murray Weidenbaum persuaded them that such high real growth estimates were likely to be too optimistic.

Some of us outside the Administration criticized this forecast as inconsistent with the Federal Reserve's very tight monetary policy (Feldstein, (1981b). The interest rate on three month Treasury bills was over 14 percent and long term government bonds had a 13 percent interest rate. The Fed had expressed a determination to slow the growth of nominal spending and bring down inflation.

In contrast to the Administration's prediction of nominal GNP growth over 13 percent, the actual nominal GNP growth in the fiscal year that began in October 1981 was only 4.2 percent with real GNP falling at a rate of nearly 2.0 percent. Although real GNP recovered and grew more rapidly over the next few years, inflation came down much more rapidly than either the Administration or others had forecast, resulting in substantially less "bracket creep" and lower tax revenues than had been forecast.

Although the press joked that the Administration's forecast had been prepared by Ms. Rosy Scenario, the big revenue error in the five year budget forecast came not from overoptimism but from being too pessimistic about the speed with which inflation would be reduced. Nevertheless, the label "Rosy Scenario" stuck and the Administration's lack of credibility greatly increased the difficulty of the fiscal year 1983 budget negotiations in 1982 and reduced public support for the Administration's policies.

5.3 *The 1982 Tax Increase*

The weakness of the economy and the rise of interest rates in 1981 quickly made it clear to careful analysts that the budget deficit would be more than the administration's initial projections. But it was the sharp decline of the stock market between March of 1981 and a year later that, more than any other single thing, convinced the President that action was needed to reduce the deficit.[12]

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[12] The fall of the Dow Jones average from 1000 in March 1981 to about 800 a year later reflected the combination of a weak economy, high interest rates, and the tax changes that reduced the market value of existing capital stock. (By making it less expensive to make new investments in plant and equipment, the 1981 accelerated depreciation rules reduced the value of the existing capital stock and therefore of share prices that represented the ownership of that capital; see Feldstein (1981c).

Many financial analysts blamed the stock market decline on the prospect that the fiscal policy would cause large budget deficits which would keep real interest rates high and which might prevent a decline in inflation. The President was persuaded (primarily by Jim Baker and Dave Stockman) that the stock market's decline was evidence that action to shrink the deficit was necessary. Formal negotiations with the Democratic and Republican Congressional leadership produced a package of tax increases on business. These tax increases were achieved primarily by repealing some of the generous depreciation provisions of the 1981 tax legislation and the so-called "safe-harbor leasing rules" that permitted interfirm transfers of tax benefits. The package of tax changes would raise $17 billion in 1983, $38 billion in 1984, and higher amounts in subsequent years.[13]

Although I was not in the Administration at the time, I gathered from subsequent conversations with some of those who were involved in the 1982 budget negotiation that the President was persuaded to accept the higher taxes by the assertions of the Administration's negotiators (Jim Baker and Dave Stockman) that the Congressional leadership had agreed to three dollars of outlay reductions for each dollar of additional tax revenue. Since a formal agreement between the Administration and the Congressional leaders was never completed, the "details" about the nature of the spending cuts were never spelled out for the President. In fact, the spending cuts that the negotiators were discussing involved little more than some dubious savings through management improvements and the projected reductions in interest

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[13] These tax changes are discussed in section 2.3.1 of my paper, "Tax Policy in the 1980s: A Personal View." (1993)

on the national debt that the budgeteers assumed would follow from lower interest rates and a smaller debt.

The Administration's negotiators knew that the spending reductions would never be achieved but preferred to maintain the fiction to get the President's support for the tax increase. During the years that I was in the Administration, the President complained frequently that the Congress had failed to deliver on its promise to cut spending. Republican Congressional leaders repeatedly told the President that this was not true since a final agreement had not been reached with the Congress in 1982. But, more importantly, the facts about the nature of the projected spending cuts themselves were never told to the President. As a result, the President always looked back on the 1982 tax legislation as unsatisfactory because he felt that he never got the spending cuts that he had been promised. That in turn made it difficult to get him to consider future budget deals with the Congress in which he would accept higher taxes in exchange for a Congressional willingness to accept further cuts in nondefense spending.

5.4 *The February 1983 Budget*

I joined the Administration in late August of 1982 and immediately began to work on the deficit issue. The $49 billion increase in the budget deficit between 1981 and 1982 was due almost completely to the deep recession.[14] But although economic recovery would eventually eliminate the cyclical component of the deficit, the tax changes that had been enacted and the spending rules that were on the books implied that the deficit would continue

[14] According to Congressional Budget Office calculations, the structural deficit increased by only $6 billion between 1981 and 1982.

to grow. Estimating the extent of that deficit growth was critical to planning the five year budget to be submitted in February 1983.

It is politically true and economically desirable that substantial deficit reduction can only be achieved over a number of years. The 1983 budget would provide a suitable five year policy horizon for implementing a deficit reduction plan. The necessary magnitude of the explicit deficit reduction (through new spending cuts or additional changes in tax rules) would depend critically on the extent to which economic growth (and inflation until the indexing of tax brackets became effective in 1985) would raise revenue without explicit legislative changes.

The medium term economic forecast that would provide the framework for the budget was therefore crucial for deciding on the needed changes in spending and taxes. Since the budget was not to be used as a tool of short-run demand management, it seemed best to focus on estimating the overall rate of growth to the end of the five year budget period and not on the year to year or quarter to quarter fluctuations along the way. Moreover, anything proposed in the February 1983 budget would not take effect before 1984.

With the help of Bill Poole (the CEA member with responsibility for macroeconomic forecasting) and Larry Summers (who was serving as special Domestic Policy Economist on the CEA staff), I prepared a forecast that reflected what we regarded as consensus estimates of the likely changes in labor force and in productivity. We concluded that the most likely annual rate of real economic growth from the first quarter of 1983 to the final quarter of 1988 was 4.0 percent. This was clearly above the long-run potential growth rate of the economy but reflected the recovery from the very deep recession at the time of the forecast.

While I was quite happy to defend a four percent trend rate of real GNP growth for 1983 through 1988, there was the awkward question of how to deal with the transition from recession to recovery. In the late fall of 1982, when the economic forecast had to be made final so that revenue and outlay estimates based on it could be calculated by the Treasury and OMB, there was no clear evidence of an economic upturn (the November trough only became clear in the following year). Most private forecasters were predicting that the recession would end during the next twelve months but there was no clear consensus on the likely time of the upturn or on the extent of further deterioration before the upturn began.

For the purpose of the five-year budget, however, this short run uncertainty was not relevant. But if we assumed four percent real growth for each quarter in 1983, there was a substantial risk that the entire budget would be dismissed by the Congress and serious private analysts as the work of Ms. Rosy Scenario if the first quarter of the year continued to show an economic decline.

It seemed better therefore to assume a lower rate of real growth for the first quarter and then to revert to a 4 percent rate for each quarter until the end of 1988, thereby emphasizing that after the first quarter we were using only the four percent average growth rate rather than trying to make short-term predictions. A one percent rate for the first quarter had the virtue of being greater than zero but low enough that it would not cast doubt on the forecast as a whole even if the economy was still in decline when the budget was presented.

With this assumption, our forecast implied a cumulative 3.9 percent of growth from the fourth quarter of 1982 to the fourth quarter of 1988. This forecast was criticized inside

the Administration by those who said that it showed too little faith in the efficacy of the Administration's program and who worried that it would imply a need for tax increases to achieve an acceptable deficit forecast. In fact, however, the real rate of economic growth during the five year forecast period to the fourth quarter of 1988 eventually turned out to be 4.1 percent. The cumulative error means that our forecast implied an underestimate of the fiscal year 1988 revenue of only about $20 billion or 15 percent of the actual deficit in that year.

During the fall of 1982 I spent considerable time explaining publicly as well as inside the Administration that the recent deficit surge was cyclical but that, as the economy recovered, we would still face a substantial structural deficit. I explained also that a persistent structural deficit would inevitably lead to reduced investment in plant and equipment and therefore to lower levels of future real incomes. In the shorter term, the crowding out of direct investment would be postponed by a capital inflow from abroad as the rise in the dollar (that had already begun) depressed net exports. But I was convinced that such a capital inflow would be only temporary and that a persistent decline in domestic saving caused by budget deficits would depress investment by a comparable amount.[15] I stressed the long-run adverse effects of the deficit: reduced capital formation, lower productivity, and a need for higher taxes in the future just to keep up with the interest costs. But while stressing the long-run effects, I also recognized the myopia of the political process

[15] My research with Charles Horioka (Feldstein and Horioka, 1980) had persuaded me that chronically lower domestic saving rates depress domestic investment by a nearly equal amount. I gave no weight to the so-called Ricardian equivalence idea that larger deficits might induce equal increases in private saving.

and therefore discussed ways in which the deficit could hurt the economy in the nearer term. The crowding out of investment and the decline in net exports meant a lopsided recovery with manufacturing and construction depressed relative to service industries. I argued that a lopsided recovery was inherently less stable than a recovery with a sustainable balance of activities. In addition, the projection of large future deficits could actually depress the overall current level of private spending by raising real long-term interest rates.[16]

I emphasized the desirability of a "backloaded" multiyear strategy for dealing with the deficit. I wanted to see a budget enacted in 1983 that would present a reliable and predictable reduction in the deficit over time, leading to a balanced budget at the end of five years. The ideal path of deficit reduction would be "backloaded" with just enough deficit reduction in the first year to reassure markets that the deficit would actually decline in the future.

I explained the rationale for such a "reliable and predictable backloaded multiyear plan" both during our internal budget deliberations and, after the President submitted his budget plan, in speeches and testimony. It would be wrong to have a large fiscal contraction just as the recovery was beginning. In contrast, a reliable multiyear deficit reduction plan leading to a balance budget would cause a reduction in long-term real interest rates and in the dollar as financial markets became convinced that deficit reduction would actually occur as predicted. After a further lag of about a year, the lower real interest rate and lower dollar would result in higher levels of investment spending and net exports. The increased aggregate

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[16] My views of the adverse effects of structural budget deficits appeared as chapter one of the Economic Report of the President for 1983 and for 1984 as well as in Congressional testimony and public speeches.

demand from this future spending would balance the contractionary effect of the future deficit reduction.

I emphasized that there was of course no way to coordinate the exact timing of the fiscal contraction and the private economic response. The shift from deficit stimulus to increases in investment and net exports involved risks of a "timing mismatch" that could cause the predicted expansion to stall temporarily. But the best strategy for avoiding the permanent damage of persistent large deficits would be to enact a reliable multiyear deficit reduction plan.

The preliminary estimates for the budget to be presented in February 1983 implied that with no change in taxes or spending there would be substantial deficits in each of the next five years. Even with the spending cuts that could politically be proposed in the budget (but probably not enacted), the projected deficits would remain unacceptably large. To show significantly declining deficits over the next five years, some kind of tax increase would be needed.

This conclusion, coming on the heels of the 1982 tax increase, was strongly resisted. The only alternative was to increase the projected rate of economic growth. The key White House staff dealing with this issue (Chief of Staff Jim Baker and his deputy, Dick Darman) argued that even if four percent growth was the most likely estimate it would be politically much better to project a five percent annual growth rate. Adding "just one point" to real GNP growth rate for five years would reduce the projected budget deficit by about two percent of GNP. That stronger growth plus the spending cuts that could be proposed in the President's budget would eliminate the budget deficit as an immediate political problem.

I resisted, pointing out that five percent for five years was extremely unlikely. They countered that it might not be likely but that five consecutive years with an average growth rate over five percent had actually occurred in the 1960s. I reminded them of the Vietnam war, the subsequent rise in inflation after that expansion had driven the unemployment rate down to an unsustainable 3.7 percent, and our commitment to low inflation. Even if there was some chance that such growth might occur, it was sufficiently unlikely that it would be a mistake to base policy on that assumption. Moreover, a prediction of a five percent GNP growth rate for five years would deny credibility to the forecast and to the budget based on it.

None of this was particularly persuasive to those who saw the budget as a political statement rather than a fiscal planning tool and who wanted to avoid a forecast that would force a choice between large deficits and another tax increase. But I was not going to be pushed into a forecast that I thought was implausible or a budget plan that I thought hid the problem. In the end, the CEA forecast was accepted as the basis for the budget.

The "supply siders" in the Treasury also called for projecting stronger growth on the grounds that, once the recovery began, the revenue gains from the tax cuts enacted in 1981 would be so great that no further tax changes would be needed to eliminate the deficit. They also argued that even if the deficit persisted it would be better to allow the deficit to continue than to raise taxes since higher taxes would hurt incentives while there was no evidence that deficits actually did any harm.

The Treasury staff never explicitly raised the so-called "Ricardian equivalence argument" (that large budget deficits didn't matter because any increase in the government

deficit would induce an equally large increase in private saving), presumably because it would be impossible to persuade non-economists to take it seriously. Instead the debate focused on whether deficits raised real interest rates. There was no doubt that real long-term interest rates were extremely high by past standards. Some argued that this was due to the investment incentives of the 1981 tax legislation. Others argued that it was because of the instability of monetary policy. Treasury Secretary Regan strongly resisted the idea that budget deficits were responsible for high interest rates but occasionally said that budget deficits might raise interest rates because people in financial markets thought they did even though they didn't.

A small group of senior administration officials met for dinner soon after Christmas 1982 for a preliminary informal discussion of the budget plan. Secretary of State George Schultz, who generally didn't get involved in detailed economic policies even though he had been an OMB Director and Treasury Secretary in the Nixon administration, joined the dinner and proposed an energy tax and energy import fee. These were to become the centerpieces of the tax component of the 1983 budget.

To deal with the resistance to any tax increase, Ed Harper and I suggested as a compromise that the tax increase be made contingent on the future deficit: the tax increase would be legislated in 1983 but would only take effect in 1985 if the deficit remained above a relatively low threshold level. I had no doubt that the deficit would exceed that threshold and therefore expected that the contingent "standby tax" would be "triggered on." If the "supply siders" and other optimists were right in their belief that growth would be so strong that the deficit would shrink rapidly, the contingent standby tax would be no tax at all. The

contingent feature also gave the White House staff and others the ability to talk about their own personal belief that growth would be stronger than our projected four percent and therefore that there would be no tax increase.

Either way, the budget with a contingent tax would meet the need for a reliable multiyear deficit reduction plan. With the standby tax, the deficit would shrink to 1.6 percent of GNP by 1987-88. Dave Stockman, who was also skeptical of the supply siders' claims and eager for a plan that would actually reduce the outyear deficits, supported the contingent tax idea.

The combination of spending cuts and the "conditional" tax increase was accepted by the President as part of the February 1983 budget plan for FY1984 and beyond. When the budget was first made public, there was a generally favorable reaction to the "realism" of the forecast and the "flexibility" of the President in including the standby tax. Our conversations with the Democratic Congressional leadership suggested that there might be a basis for developing a compromise that would actually provide for multiyear declining deficits.

But that was not what either the White House political strategists or Treasury Secretary Don Regan, following their lead, wanted. They had accepted the proposal for a tax increase as part of the President's budget only because that was the only way to make significantly declining deficits compatible with the CEA forecast. But they didn't want Congress to enact another tax increase that would be attributed to President Reagan. They made certain that it would not be enacted by asserting that the contingent tax increase would be acceptable to the President only if all of the President's proposed spending cuts were also accepted by the Congress. By adopting a very tough no-compromise strategy in discussing

the budget with the Democrats, the White House and the Treasury were able to sink the entire budget and blame Congress for the continued deficits that the President had proposed to reduce.

Although the tough position taken by the White House and the Treasury soon caused the press to declare the President's budget dead, it was never withdrawn. I continued to speak out loudly in favor of it, pointing out the harm of persistent deficits, stressing the President's desire to do something about them, and explaining the case for a multiyear reliable deficit reduction plan even if it had to include a tax increase. Moreover, even if the President's plan was dead for that year, I took the many opportunities that came along to educate the Congress and the public about the adverse effects of protracted deficits and the desirability of a backloaded multiyear strategy of deficit reduction.

My emphasis on the potential adverse effects of budget deficits and on the president's willingness to raise taxes as well as reduce spending made me unpopular with the White House political operatives, particularly with Jim Baker and Dick Darman. This led to a series of stories in the press about "the White House's" displeasure with my statements that many who were outside the Administration incorrectly interpreted as reflecting the President's opinion.

I recognized that such "leaks" served many purposes. At the substantive political level, they positioned the Administration on both sides of the budget issue: I said deficits are bad and taxes might be accepted as part of a program while "the White House" said the opposite. Leaks also served as a potential form of intimidation, trying to stop my remarks or even to get me to resign. They never succeeded at either of those goals; indeed, when the

press said I was being "silenced," I felt that I had no choice but to make further comments to show that I had not been silenced. Some of the White House staff also used leaks as "favors" to be given to friendly journalists in exchange for favorable press treatment for themselves.

When the leaks about me and the deficit got both loud and frequent, I eventually asked the President to review the parts of my "standard speech" that dealt with the deficit and the budget. He read the pages and gave his "OK" with only the suggestion that I mention the spending cuts in his budget plan before I talk about the proposed tax increases.

5.5 *The February 1984 Budget*

Although the Social Security legislation had improved the revenue outlook, the future deficit situation still looked very grim in the fall of 1983 when we began planning for the February 1984 budget. The economic forecast implied budget deficits of at least $200 billion a year for the next five years, despite steady economic growth and declines in interest rates on government debt that many outsiders considered to be too optimistic. Budget deficits of this magnitude would absorb more than two-thirds of net private saving, leaving a net national saving rate of only about two percent of GDP. We would either be dependent on substantial capital inflows from the rest of the world (with the associated massive trade deficit) or see a sharp decline in net investment in business plant and equipment and in housing.

The internal debate about this budget was in many ways a replay of the discussions of the previous year, but those who had opposed tax increases in 1983 were even less receptive to a serious deficit reduction plan now because of three developments: the strong economic

growth of 1983, the failure of the budget discussions in 1983, and the upcoming 1984 election.

Real GNP had grown seven percent from the fourth quarter of 1982 to the fourth quarter of 1983, more than twice the rate that we had projected. The Treasury supply siders argued that the strong growth in 1983 was a harbinger of continued rapid growth that would generate much more revenue than we were projecting. Dick Darman argued that the strong growth in 1983 justified assuming that we would grow at 5 percent for the next five years rather than the four percent that we were projecting. The cumulative five percent of real GNP would mean additional tax revenue of about two percent of GNP by the end of the forecast period, making it unnecessary to propose any tax increase in the 1984 election-year budget.

While the very strong growth in 1983 made it harder to defend our five year four-percent forecast, I reiterated that our underestimate for 1983 was a matter of not knowing when the recovery would begin, that GNP growth in the first year of recoveries was generally in the six or seven percent range, and that four percent was still the most likely growth over a five year period. The only concession that I was prepared to make was to assume four percent for the next five years from the higher base at the end of 1983.

The failure to reach any agreement on the previous budget proposal, despite the Administration's seeming willingness to accept a tax increase as part of an overall package, was also seen by some as an indication that there was no point in trying to compromise in the 1984 budget. In any case, we would be in an election year when it would be politically attractive to argue that powerful economic growth would solve all problems.

Dave Stockman and I agreed that the deficit problem was too serious to ignore and that an effort had to be made to make some progress. Both of us had been very vocal over the past year about the need for budget action and did not want to go before Congress and the public in early January 1984 with a budget that called for no action and that projected that we would grow our way out of the problem.

I was encouraged also by several Cabinet members who agreed that the deficit had to be reduced and that a tax increase should be accepted as part of a plan for deficit reduction. This group included Special Trade Representative Bill Brock, Commerce Secretary Malcolm Baldridge and Secretary of State George Schultz. Each had his own reason for not speaking out publicly about his views on this subject but they all did make their position clear to the President on at least one occasion during the 1984 budget deliberations. Federal Reserve Chairman Paul Volcker urged deficit reduction both privately and publicly. Most of my academic economist friends also supported deficit reduction and agreed that the right tax increases were better than continued large deficits. There was no unanimity among businessmen but the self-selecting group that spoke to me generally supported the view that deficit reduction, including higher taxes, was desirable. Too often, however, when a group of businessmen were given an opportunity to meet with the President, they would tell me privately how important the deficit reduction was and how they recognized that tax increases would have to be part of the package but then would not give the same message to the President. Instead, most of them would either settle for telling him what a fine job he was doing or would say that they supported his call for deficit reduction without mentioning the need for higher taxes.

In my own meetings with the President during the fall of 1983, I tried to convince him of two things. The first was that he had already made dramatic reductions in non-defense spending (other than the Social Security and Medicare programs). After a political lifetime of campaigning against such spending, the President could hardly believe that he had actually succeeded in turning the trend around and cutting such spending by enough to bring the projected GDP share down to where it had been in the 1960s before the "Great Society" programs. I emphasized that just limiting such spending to the present real "current service level" that he had already achieved would bring the level of non-defense discretionary spending to about 3.2 percent of GDP by the end of his second term in 1988. There was no realistic scope for significantly reducing the projected budget deficit by further cuts in such programs.

My second major point was that we could not expect to grow our way out of the deficit through greater revenue associated with economic growth faster than the four percent a year that we were now projecting. With Social Security essentially off-limits because of the 1983 Social Security agreement, some additional taxes would therefore be needed to shrink the deficit even if further progress could be made on discretionary programs and Medicare.

I think I did eventually persuade the President that he had succeeded in cutting nondefense discretionary spending and smaller entitlement programs substantially and that there was little scope for deficit reduction through additional cuts in those programs. But I don't think that I persuaded him that higher economic growth would not reduce the deficit by more than we were projecting. He accepted my economic projections as the basis for the

budget and never tried to persuade me to change either the economic assumptions or the deficit implications, but I believe he continued to hope that higher growth would come to his rescue.

I recall that on one occasion I said to him that, while economic growth at five percent a year for five years was "possible," it was very unlikely and it would not be prudent to base budget policy on such an unlikely event. When I reflected on that meeting later that day, I realized that saying that something was "unlikely" and "imprudent" was not a way of persuading Ronald Reagan. Such an argument might persuade a businessman who was accustomed to acting cautiously but was much less appealing to a politician, especially to someone with Ronald Reagan's life history. Here was a man who had gone from being a local sports announcer to a wealthy movie actor. When his acting career ended, he went on to become governor of the largest state in the nation without any prior public office. And after a resounding defeat in seeking the Republican presidential nomination a few years earlier, he won the 1980 nomination and went on to become president. And I was trying to tell him not to believe in something because it was unlikely!

Dave Stockman tried a different approach to persuading the President that it would not be possible to cut spending enough to bring the deficit down to an acceptable level without additional tax revenue. Stockman divided the overall budget into dozens of small parts and prepared three sets of options for each part: small cuts that would probably be acceptable to Congress but that would in the aggregate produce very little overall deficit reduction; moderate spending cuts that would be hard to get through Congress but that nevertheless would only add up to a small overall spending cut; and deep spending cuts that

would be impossible to enact and that the President probably wouldn't want to propose in an election year. The budget group spent several afternoons reviewing these options one-by-one with the President so that he could in each case choose one option. Not surprisingly, the President choose the middle option in almost every case. At the end, Stockman announced that the overall spending cut, even if all of these could be passed, would be relatively small.

Although Stockman had hoped that this would convince the President, I felt from the first time that he described his plan to me, that it would not succeed. After all, in each budget area Stockman was only showing the President a small number of possible budget changes. The President continued to believe that there were possibilities that he was not being shown. He kept hoping that there was some general overhaul of the domestic programs that would permit major savings rather than the small savings that came from looking at each program in detail and in isolation.

Although the President probably believed that the future tax revenue would be greater than we were projecting and that there were ways of cutting spending through reorganization that Stockman had not discovered, the President was locked by his own decisions on the individual spending programs into a budget that projected very large deficits for the next five years. The only way to reduce them was through changes in tax rules.

The Treasury's Office of Tax Analysis prepared a list of detailed tax reforms, primarily aimed at technical aspects of the measurement of business income. The President agreed to incorporate these "revenue raisers" into his budget with the explanation that they were not really "tax increases" but were essentially closing loopholes so that businesses would pay the taxes that they should.

The final budget also included reductions in the requested levels of future defense appropriations. When the President met with the entire cabinet to describe the proposed budget that would be released the next day, he noted that it was intended to be flexible and a basis for negotiating with the Congress since "everything was on the table" with "no restrictions in advance." He said that he expected that the Congress would be pleasantly surprised by his willingness to compromise on a revenue increase and smaller defense spending and that it would be possible to find agreement with the Democrats who controlled both houses of Congress.

The deficit reduction plan was certainly not as much as Dave Stockman and I had originally hoped for but it was much better than it might have been. In addition, the deficit cuts in this election year budget were to be described as a "downpayment" on the additional deficit reduction measures to be proposed after the election.

The process of presenting this budget to the public taught me an interesting lesson in political communication. Since the economic forecast is released at the same time as the budget, I was called upon to brief the White House press. As a teacher who always tried to explain things as clearly as possible, I explained that our forecast was unchanged with four percent growth rates and that substantial harmful deficits would remain if no action was taken but that the President's proposed budget would reduce the deficit substantially by a combination of tax increases and cuts in the growth of defense spending as well as by lower nondefense spending.

The statement that the President's budget would include "tax increases" and "lower defense spending" coming from the mouth of the CEA chairman was more newsworthy than

I had imagined. What I said was perfectly accurate and in line with the details that would be released later that day by Dave Stockman and others. But my language was too unambiguous. At the same time that I was saying that we favored "tax increases" and "smaller increases in defense spending," the President was addressing Congressional Republicans and saying that his budget "would not raise taxes on hard working American families" or "threaten America's safety through reckless defense cuts."[17] The evening television news could pair our statements and make it look like the Administration was in disarray and that, "once again" I was calling for tax increases and less defense spending while the President was not willing to yield on either.

Of course, there was no conflict between our statements. The Administration's proposed tax increases on business "would not raise taxes on hard working American families" and the lower level of defense spending were not "reckless" and would not "threaten our nation's safety". But by Washington's standards I had been too unambiguous in my statement, instead of hiding behind phrases like "the Administrations's budget puts everything on the table."

The Democrats responded to the President's budget with proposals for much lower defense spending and with attacks on his proposed reductions in domestic spending. In the end, defense spending was lower than the President had requested and business taxes were raised but nondefense spending was treated as might have been expected in an election year.

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[17] These are not precise quotes but my recollections of the type of language used at the time.

5.6 *Deficit Reduction After 1984*

The combination of higher tax revenue and lower spending, both relative to GDP, reduced the deficit by 1.0 percent of GDP between 1984 and 1990 (and 2.1 percent of GDP if the deposit insurance payments are excluded). Taxes rose from 18.0 percent of GDP in 1984 to 18.9 percent in 1990. This reflected in part the delayed effects of the tax changes that had been enacted in 1982, 1983 and 1984. It also reflected the continuing economic recovery and the drift of individuals into higher tax brackets.

Spending on non-defense programs (other than net interest and the deposit insurance payments) fell by 1.0 percent of GDP during these same years. With no net change in the Social Security and Medicare programs as a percentage of GDP, the entire fall in saving was in the domestic discretionary and small entitlement programs which together fell from 7.1 percent of GDP in 1984 to 6.1 percent in 1990.

Part of the reduction in spending was achieved with the help of the Gramm-Rudman legislation which set explicit multiyear deficit reduction targets and provided for automatic spending reductions ("sequestrations") if the targets were not met. The law provided that these automatic spending cuts would be divided equally between defense outlays and certain nondefense programs. Since Social Security, Medicare and certain other nondefense programs were excluded from the automatic spending cuts, the imposed cuts were concentrated on a relatively narrow range of the budget, requiring very substantial proportional cuts in the remaining programs if the deficit targets were not satisfied. Because such cuts would be politically too painful, Congress and the Administration colluded to evade the spirit of the Gramm-Rudman legislation through a series of budget tricks -- shifting things

on and off budget, moving items between adjacent years, etc. Nevertheless, I believe that Gramm-Rudman did help to reduce the deficit by focusing attention on the size of the deficit, by setting explicit targets, and by "requiring" across the board spending cuts in the first year after enactment that politicians would not have had the courage to propose and enact explicitly.

The decade ended with the 1990 structural deficit (excluding deposit insurance payments) at $150 billion or 2.8 percent of gross domestic product. This was a significant improvement from the earlier peak of the structural deficit (4.4 percent of GDP in 1985) and substantially less than it would have been without the legislative initiatives that began in 1982.

In retrospect, the deficit did not do enough short-run harm to force the Administration and the Congress to accept the political costs of deficit reduction. Despite the deficit, the economy continued to grow throughout the decade in the longest peacetime expansion while tight monetary policy kept inflation under control. The nation's net saving rate was greatly depressed but the inflow of capital from the rest of the world helped to maintain net investment. The consequences of the high budget deficit and resulting low rate of national investment were beginning to be felt in slower real economic growth but the decline in growth was so small and gradual and its link to budget deficits was so unclear to the public that it failed to induce the tough political actions that would be needed to eliminate the budget deficit and raise national saving.

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