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ABSTRACT

This paper examines the record of employment and unemployment between 1982 and 1986 and discusses a variety of cyclical and structural employment policies that were considered but not implemented during the years 1982-84 when I served as chairman of the Council of Economic Advisers. Employment rose by 11 million jobs during the cyclical recovery of those four years, lowering the unemployment rate from 10.8 percent to 6.6 percent. Even before the recovery was visible, the Reagan administration supported the tight Federal Reserve policy to reverse the high inflation at the end of the 1970s. The policies to reduce structural unemployment that were considered but not enacted at the time have become law in later years: a gradual decline in the real minimum wage, the full taxation of unemployment insurance, and a work requirement for those on welfare.

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**Employment Policy of the Middle Reagan Years:
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Several years ago I organized an NBER study of American economic policy in the 1980s (Feldstein, 1993). The study involved eleven detailed scholarly papers on various aspects of economic policy during those years. These papers then served as background material for a conference at which some of the key participants in the policy process discussed their own perceptions of what had occurred. For the final volume I added a long personal essay based primarily on my experience as chairman of the Council of Economic Advisers during 1982 through 1984.

It is noteworthy that none of the essays in the volume dealt with employment policy. That is not surprising since, relative to the other aspects of government policy like taxation and trade, there were very few policy initiatives during the Reagan years. It is interesting, however, to ask why that was true and what policy options were contemplated but not enacted. It is with that in mind that I have subtitled this essay about the employment policy in those years: "What Didn't Happen and Why It Didn't Happen." It's a fascinating story of remarkably successful outcomes, of the favorable impact of benign neglect, and of the eventual realization of policy ideas that were politically premature at that time.

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I. The Employment Situation in Late 1982

It's is useful to begin by recalling the dire state of the labor market at the end of 1982. When I arrived in Washington as CEA Chairman in August 1982, the unemployment rate had reached 9.9 percent, up 2.5 percentage points in the past 12 months. There were 10.9 million unemployed, an increase of almost 3 million since President Reagan had entered office just 18 months earlier. When a newspaper asked my Harvard colleague Ken Galbraith for a reaction to my appointment to the CEA chairmanship, he quipped that I was foolish to be signing on as a passenger on the Titanic.

Four months later, the unemployment (as then measured) rose to more than 12 million, an unemployment rate of 10.8 percent. Nothing like this had been seen before in the postwar period.

The 1983 Annual Report of the Council of Economic Advisers devoted an entire chapter to unemployment and began with the words: "Unemployment is the most serious economic problem now facing the United States." (page 29) But although the chapter analyzed a variety of policies that might deal with cyclical and structural unemployment, very little of substance was actually done. Before looking in detail at policies that were considered and the reasons that they were not pursued, it is useful to remind ourselves of the rapid improvement in employment and unemployment that occurred over the next two years despite the lack of an active employment policy.

II. Rapid Improvements in Unemployment Beginning in 1983

Although we didn't know it at the time, the business cycle reached its lowest point in November 1982 and was poised to start a very rapid expansion. Between December 1982 and December 1983, employment rose by nearly four million jobs and the number of unemployed fell by 2.7 million. The unemployment rate was down to 8.1 percent.

One year later, employment had increased by an additional 3.2 million jobs and the number of unemployed was down by more than one million, bringing the unemployment rate down to 7.1 percent. This was lower than it had been at the start of the Reagan administration.

Since I've been asked to focus on the "middle years" of the Reagan administration I'll note that by the end of 1986 employment was up by 4 million more jobs and the unemployment rate was down to 6.6 percent. The cumulative increase in these four years was more than 11 million jobs and an unemployment rate decline of four percentage points.

Not surprisingly, this expansion helped all demographic groups. The unemployment rate of teenagers fell from 24 percent at the end of 1982 to 17.5 percent at the end of 1986. Among nonwhites the drop was from 19 percent to 12 percent. And among women the drop was from 9 percent to less than 6 percent.

Whatever the Reagan administration was doing — or not doing — was clearly a remarkable success. And while employment was booming, the inflation performance was also very good with the rate of increase of the CPI actually declining from 6.2 percent for 1982 to 3.6 percent for 1985 and, thanks to a drop in oil prices, to just 1.9 percent in 1986.

III. High Unemployment and Macroeconomic Policy

With employment surging and the unemployment rate dropping, it is not surprising that the Reagan administration did not pursue more active employment policies after the spring of 1983. What needs explanation is the lack of macroeconomic policy or explicit labor market policies in the previous period of high and rising unemployment.

When I arrived in August of 1982 there was certainly no reason for confidence that the

recession would soon end and even less reason to believe that, when it did, the unemployment situation would improve so rapidly. And yet in the 1982 election campaign the Republic Party took as its theme the slogan "Stay the course" and there were no substantial countercyclical employment policies on the Administration's agenda as the year 1982 came to an end.

To understand this, it is necessary to recall why the unemployment rate had become so high in the first place, rising from 5.8 percent in 1979 to 7.5 percent at the start of 1981 and 10.8 percent at the end of 1982. The reason of course was the tightening of monetary policy to reduce inflation.

The rate of CPI inflation had increased from about 6 percent in 1975-77 to 9 percent in 1978 and 13 percent in 1979. Paul Volcker, then the recently appointed Federal Reserve Chairman, convinced his colleagues at the Federal Reserve that a sharp change in monetary policy was needed to bring inflation under control. The federal funds rate was raised from less than 8 percent in 1978 to almost 18 percent in April of 1980. When that led to a sharp rise in unemployment, President Carter "persuaded" the Fed to ease monetary policy. The federal funds rate was back down to 9 percent by July and the recession came to an end after just six months. As a result, the inflation rate continued at a double digit pace.

The public's dissatisfaction with the high inflation was one of the key reasons that Ronald Reagan was elected president. He made it clear that he would support the Federal Reserve as it pursued whatever policy it deemed necessary to reduce inflation. The Fed raised interest rates immediately after the election, pushing the fed funds rate over 18 percent in December 1980 and over 19 percent in January 1981.

President Reagan accepted the high unemployment as the price that had to be paid to reduce inflation. He rightly regarded the high inflation as the result of the bad policies of the Carter

administration and of the Federal Reserve during the years when it was chaired by William Miller. He understood that trying to reduce the unemployment rate prematurely by an easing of monetary policy would leave the inflation problem uncured.

The 1983 Annual Report of the Council of Economic Advisers, written at the end of 1982, rejected the idea of a more expansionary economic policy with these words: "During periods of disinflation and recession, the measures available to reduce the pain of the transition from accelerating inflation to price stability are limited. Greater fiscal or monetary stimulus might increase employment, but only at the risk of igniting inflation." In 1982 the rate of inflation was beginning to slow down, but the 1982 level of consumer prices was still more than 6 percent over the 1981 price level. Although the CEA estimated that the inflation threshold rate of unemployment (the NAIRU) was probably between 6 and 7 percent, the CEA's advice was to allow the economy to evolve to that level slowly so that the inflation rate could continue to decline.

Paul Volcker and his colleagues felt confident enough about the progress in reducing inflation that the Fed began easing policy toward the end of 1982, but did so at a pace that kept the unemployment rate above 7 percent until 1985. With the strong progress on both inflation and unemployment, the Reagan administration had no reason to quarrel with the Federal Reserve policy.

Because this session deals with the Employment Act of 1946, something should also be said about fiscal policy. When the 1946 Act was passed, it was assumed that fiscal policy rather than monetary policy would be used to maintain full employment. But by 1982 the economics profession's faith in fiscal stabilization policy had been eroded. Empirical research had diminished the estimated fiscal multiplier by taking into account relatively inelastic money demand, endogenous price responses, and leakages through foreign trade. A shift from a comparative static analysis to

a dynamic framework also made it clear that lags in the impact of fiscal policy were very important and that the length of those lags was very uncertain, making it easy for fiscal policy to add its expansionary impact long after the trough of the recession and therefore to be destabilizing rather than stabilizing. The 1983 CEA report cited evidence on these lags, noting that "a recent study by the Office of Management and Budget found that 80 percent of the outlays for local public works projects designed to stimulate recovery from the 1974-75 recession occurred more than 2 ½ years after the trough of the recession (p. 40)."

An interesting confirmation of the consensus that fiscal policy was inappropriate came shortly after the Administration presented its budget in February 1983. House Speaker Thomas P. (Tip) O'Neill met with President Reagan in the Oval Office to give a Democratic reaction to the Administration's budget. Although the most recent unemployment rate was still over 10 percent, Speaker O'Neill made it clear that he would not seek more than a token amount of fiscal expansion, just enough so that he could assert that he and the Democrats had sought stimulative policy in this way. When I testified to several Congressional committees in subsequent weeks about the Administration's budget plan there was much criticism of the high unemployment rate and of our seemingly optimistic forecast that the economy would grow by more than 3 percent in 1983, but no attempt to pressure the administration to pursue a more expansionary fiscal policy.

IV. Policies to Reduce Structural Unemployment

Fiscal and monetary policies are not the only ways to try to reduce unemployment. There are in principle also a wide variety of microeconomic policies that might have been tried to increase employment and reduce unemployment. Several of these were considered but virtually nothing was

put into effect.

Before commenting on the policies that were explicitly considered, let me say a word about the policies that were being implemented in Europe, but that had no appeal to the Reagan administration. The most significant of these were the "job protection" policies that prevented an employer from discharging a worker or that required very large severance payments. Although these appeared on the surface to help maintain employment, we recognized that their principal effect would be to discourage firms from hiring workers. The Reagan administration wanted to increase labor market flexibility and repeatedly explained the dangers of alternative policies at OECD meetings and at other places where American and European officials met.

The Reagan administration did consider four broad types of policies that might reduce structural unemployment, thereby permitting the economy to evolve toward a lower overall unemployment rate as the cyclical recovery continued. These can be described as: (1) vocational training for the disadvantaged; (2) policies to lower the cost to employers of hiring disadvantaged workers, especially young workers with low skills; (3) changes in the unemployment insurance system; and (4) work requirements for welfare recipients.

Several policies to subsidize training for disadvantaged workers were enacted during the first two years of the Regan administration. The most important of these was the Job Training Partnership Act (JTPA) of 1982 that provided federal funds to subsidize vocational training in cooperative ventures involving firms, vocational training institutions, and the government. I don't recall hearing much about this program after it was enacted and suspect that, like virtually all other training programs, it had very little effect on employment and employability, especially among male workers.

Some of us suspected that the JTPA placed too much emphasis on formal vocational education rather than on-the-job learning through informally supervised experience. I had long been an advocate of policies to lower the cost of hiring young workers so that employers could afford to give them useful experience and informal training (Feldstein, 1973a, 1973b). This logic was embodied in the administration's proposal to lower the minimum wage for young people under age 22 during the summer months. But even this very limited proposal ran into the usual opposition to any attempt to lower the minimum wage. Critics argued that it would impoverish those with low skills and would encourage firms to substitute these lower cost youths for older workers. As a result of such opposition, it never became law.

Long before coming to Washington, I had advocated a program that I called "Youth Employment Scholarships" that involved federal vouchers that young men and women who entered the labor force without post-secondary education could use to pay their employers for training opportunities (Feldstein 1973a, 1973b). I reasoned that without such vouchers low skilled youths could get jobs that paid at or near the minimum wage, but that those jobs would be dead-end jobs with little or no training or useful experience. Employers could afford to pay these low skilled workers the minimum wage, but could not do that and also provide training and supervision. The Youth Employment Scholarships would permit these low skilled youths to "buy" that training or education. Although a lower minimum wage would in theory be an alternative way to permit the purchase of on the job trainaing by low-skilled youths, I recognized the political difficulty of a substantial reduction in the minimum wage for this group and also believed that those who had not benefitted in the past from formal education might generally be unwilling to accept a significant pay cut to get on the job training. Moreover, since federal scholarships were already helping many of

those in the top half of the ability distribution, it seemed reasonable to me as a matter of fairness to extend training assistance to those who would not benefit from college.

In spite of my initial enthusiasm for this idea, I was eventually convinced by some of my own staff at the CEA and others in the interagency process that most of the money would probably go to subsidize those who were already getting such training opportunities and that the incremental cost to the government per individual who received additional training would be very large. Most of the dollars would simply raise individual wages or reduce business costs without achieving any additional training. Since the budget deficit was becoming a major problem and I was a particularly vocal critic of budget deficits within the administration, it was hard for me to argue for a new spending program that was probably not cost effective. The proposal was abandoned before it was even taken to the Cabinet Council on Economic Affairs for consideration.

The reform of unemployment insurance was another idea that I had long favored. Research that I did in the 1970s and 1980s showed that the high replacement rates and the poor system of experience rating raised the number of layoffs and increased the unemployment duration of those who became unemployed (see, e.g., Feldstein 1973b, 1974, 1975 and 1978). I favored taxing unemployment benefits as a way eliminating the extremely high replacement rates that encouraged temporary layoffs and longer unemployment spells. Including UI benefits in taxable income also seemed fair, especially since some of those benefits went to second earners in high income households.

Although the idea of taxing UI benefits was developed as one of the options that would be taken to the president in December 1982, a leak to the press brought the idea to a sudden end. On Thanksgiving weekend, the President and some of the White House staff were in California.

Someone in that group briefed the members of the White House press corps who had come to California about some of the ideas that were being considered. The press jumped on the notion of taxing UI benefits at a time when unemployment was approaching twelve million. Their attack was loud and clear; the newspaper headline that I remember declared that taxing UI was "a true turkey" just in time for Thanksgiving. The California White House group immediately issued a denial of the "rumor" that we were considering such an inhumane idea and promised that UI benefits would never be taxed. Part of the irony of this episode is that unemployment benefits were already partly taxed as a result of legislation introduced by President Carter and passed by the Democratic congress. Moreover, just a few years later it was Senator Bill Bradley and Congressman Richard Gephardt, two of the leading Congressional Democrats, who proposed the full taxation of UI benefits as part of their tax reform proposal. Although that legislation did not pass, the subsequent tax reforms did make UI fully taxable.

One further employment policy proposal is worth mentioning, especially since it came from President Reagan himself. Because of his experience as governor of California, President Reagan knew a good deal about welfare policies and felt strongly that anyone on welfare for a long period of time should be required to work. The option of "workfare" was therefore carefully considered. but in the end the President was talked out of it on the grounds that it would seem an uncaring and impractical proposal at a time when nearly 12 million people were unemployed. Although it never became policy during the Reagan years, President Clinton's promise to end "welfare as we know it" and the Republican Congress of 1996 finally brought the idea into legislation.

V. Concluding Comments

Despite the mandate of the Employment Act of 1946 and the subsequent Humphrey-Hawkins legislation, the employment policies of the middle Reagan years can best be described by what Senator Daniel Patrick Moynihan called, in a different context, "benign neglect." And benign it was. Between December 1982 and December 1986, employment rose by more than 11 million and the unemployment rate fell from 10.6 percent to 6.6 percent.

The Reagan adminstration and the Volcker Fed avoided the temptations to use expansionary fiscal and monetary policy that might otherwise have increased inflation and exacerbated the cyclical recovery. With the unemployment rate remaining above the inflation threshold level, the rate of inflation actually declined at the same time that employment soared.

We avoided also the misguided policies of "job protection" and high long-term unemployment benefits that were then being pursued and advocated in Europe and that now burden those economies with double digit unemployment rates.

And, while the structural unemployment policy proposals that we discussed were not enacted at that time, they have become law in later years: a gradual decline in the real minimum wage, the full taxation of unemployment insurance, and a work requirement for those on welfare.

It was, in short, a good time for employment and for employment policy.

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