Journal of Economic Literature
Vol. XXXIII (June 1995), pp. 777–784

Changes in American Economic Policy in the 1980s: Watershed or Pendulum Swing?*

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ECONOMIC POLICY in the 1980s may eventually become the most studied and hotly debated of any decade in United States history, even including the 1930s. Popular writings about the 1980s economy already abound in hundreds of op-ed pieces, columns, editorials, and books. However, polarization rather than consensus seems to characterize most of these popular writings as witnessed by such contrasting books as Robert Bartley's *The Seven Fat Years* (1988) with its praise for the policies of the decade and Paul Krugman's *Peddling Prosperity* (1994) which finds little if any good that came from them. In fact, most writers have been in one of two camps, either filled with mockery and scorn for the "greed decade" of the 1980s and the economic policies which define it, or filled with unwavering admiration for the polices of the 1980s which saved America from the ruin caused by the "malaise decade" in the 1970s. For many there appears to be no more consensus about these policies than at the time they were put into place. Most of the writers on either side of the debate seem to be talking past each other.

The 823 page National Bureau of Economic Research Conference volume, *American Economic Policy in the 1980s*, edited and partly written by Martin Feldstein takes a different approach. It brings together in a single volume a total of 39 economists and policy makers to analyze, discuss, critique, and rebut each others views of U.S. economic policy in the 1980s. What emerges is a thorough and fascinating survey of facts and ideas from this important period in U.S. history. The book deserves to be studied carefully by anyone with a serious interest in economic policy, much like an earlier National Bureau of Economic Research volume—Milton Friedman and Anna Schwartz's *A Monetary History of the United States, 1867–1960*—it is essential for those interested in earlier periods in the history of U.S. economic policy.

1. *The Interface Between Economic Research and Policy Decisions*

Organizing a volume like *American Economic Policy in the 1980s* is a difficult task in itself. The book is divided into eleven broad policy areas: three in macroeconomics, five in microeconomics, and three in international economics. Starting with monetary policy and ending with social insurance policy, each of these policy areas is treated in a separate chapter. Within each chapter there is a technical "background" paper by an economic expert on the facts of a particular policy and its economic rationale. A goal of each technical paper is to state exactly what the policy was

** American Economic Policy in the 1980s.* Edited by MARTIN FELDSTEIN. A National Bureau of Economic Research Conference Report. Chicago and London: University of Chicago Press, 1994. Pp. x, 823. ISBN 0–226–24093–2.

and how it was arrived at, leaving to others the task of determining the effects on the economy.

The technical papers include those by Michael Mussa on monetary policy, Don Fullerton on tax policy, James Poterba on budget policy, Jeffrey Frankel on exchange rate policy, Paul Joskow and Roger Noll on economic regulation, Kip Viscusi on health and safety regulation, Robert Litan on financial regulation, Phillip Areeda on antitrust policy, David Richardson on trade policy, Krugman on LDC debt policy, and David Wise and Richard Woodbury on policy toward the aged.

Following the technical papers in each chapter is a statement by two policy makers who had responsibility for the policy area at some time during the 1980s. The policy makers include Paul Volcker on monetary policy, David Stockman on budget policy, Elizabeth Bailey on regulation, and William Baxter on antitrust policy. Mussa is a contributor with double duty, both commenting on exchange rate policy as a former member of the Council of Economic Advisers (CEA) and preparing a lucid, well researched technical paper on monetary policy.

The technical papers and the policy statements were presented at a conference for all contributors in Williamsburg, Virginia, and each chapter concludes with a summary of the discussion about each paper from that conference. Virtually all of the contributors as well as two other former policy makers who attended the conference—William Poole and Murray Weidenbaum—have useful things to say in these discussions.

In addition to organizing the conference and serving as the book's editor, Feldstein contributes an introductory essay which touches on several of the policy areas covered in the chapters of the book. His essay, subtitled a "personal view," contains an insightful summary of his policy making experience as Chair of the Council of Economic Advisers under President Ronald Reagan. Most interesting is Feldstein's own account of the famous controversy over the budget deficit and his disagreements about this with others in the Reagan Administration. Even the context for the quip by Secretary Treasury Donald Regan that the CEA report "should be thrown in the garbage" is provided along with Feldstein's response—it was just a "throwaway line." Feldstein also lays out his views on monetary policy, tax policy, budget policy, and exchange rate policy during these years. Feldstein's own contribution is thus a mix between a technical background paper prepared for one of the chapters and the personal statement of a policy maker.

Although most of the period covered in the book coincides with the Reagan Administration, it is more than a book on Reaganomics. For example, Volcker comments on the monetary policy switch of the late 1970s, Feldstein discusses events through the start of the Bush Administration into 1990, Joskow and Noll discuss the deregulation movement which began in the late 1970s, and Charles Schultze serves as a policy discussant even though he was CEA chair under President Carter in the late 1970s. However, virtually all of these discussions tie in with Reaganomics in one way or another.

Is this choice of time period, policy issues, and contributors sufficiently comprehensive to insure that the reader comes away with a wide range of different views? The choice of time period—the focus on the Reagan years with necessary discussion of the late 1970s and early 1990s—seems neither so narrow that it cuts off the perspective of later or earlier years, nor so broad that it dilutes the analysis. It would, of course, be misleading to discuss regulatory policy or monetary policy in the 1980s without giving a review of developments in the late 1970s.

However, regarding the choice of topics and contributors, I was disappointed that there were several important omissions.

For example, there is no chapter on labor markets. Such a chapter could have addressed issues like the position the Reagan Administration took on the air traffic controller strike; during the discussions at the Williamsburg conference, Volcker stated that "the most important single action of the administration in helping the anti-inflation fight was defeating the air traffic controllers strike" (discussion, p. 162). A labor market chapter could have addressed such issues; it could also have examined welfare policy as well as the debates over changes in the in-

come distribution. And recall that the unemployment rate reached its highest level since the 1930s in 1982.

I would also have liked to have seen written contributions from supply side and monetarist economists, both of whom had a significant influence on the fiscal policy and monetary policy in the early 1980s. One important tax policy issue is whether the tax cuts the early 1980s were undertaken because policy makers in the Reagan Administration thought the cuts would generate more tax revenue or, alternatively, because they were designed to offset bracket creep. Similarly, how would a monetarist appraise the switch away from the focus on monetary aggregates in 1982? I will return to both of these issues below.

But the most serious omission in my view is that there is no discussion of the impact of rational expectations ideas—time inconsistency, credibility, monetary independence—by one of the researchers in that area. In fact, the macroeconomic parts of *American Economic Policy in the 1980s* give the impression that the "rational expectations revolution" of the 1970s had little if any influence in economic policy in the 1980s (see for example, Robert E. Lucas, Jr. and Thomas J. Sargent 1981). However, the adoption of a monetary policy with greater concern for inflation in the early 1980s as well as the focus on the importance of credibility by many monetary policy makers in the late 1980s and 1990s most likely had their intellectual underpinnings in the rational expectations revolution.

Aside from these omissions, the technical papers and the policy maker's statements in this the book make it an excellent reference work. Moreover, the mixture of factual presentations, technical policy analyses, memoir-like statements from decision makers, and the summary of the general discussion among the contributors provide an excellent portrayal of how policy is made in practice. One of the most difficult things to convey about economic policy is the nexus or interface between economic ideas and economic policy. How are economic ideas applied to policy problems in practice? How much influence did an economic idea have? In a recent book, *Macroeconomic Policy in the World Economy* (1993), based in part on my own experience in macroeconomic policy making, I make the distinction between the design of a new policy, the implementation of a new policy, and the operation of an existing policy to help delineate this interface. The mixture of contributions from economic experts and policy makers in *American Economic Policy in the 1980s* gives one a good sense for this interaction between economic ideas and economic policy. Just to mention one example, reading the reaction of Volcker to questions raised in both the technical paper and discussion on monetary policy helps to clarify why certain policies—such as the 1979 adoption of monetary targets—were enacted. Similarly the statements by Christopher DeMuth, who was in charge of administering regulatory oversight at the Office of Management and the Budget, as he began to apply cost-benefit analysis to environmental and safety regulation help us understand why this approach was not adopted more widely.

It is, of course, impossible for a single review article to summarize and critique individually each of the 39 contributions to this volume. Instead I will concentrate on some interesting and illustrative examples and then try to draw out several broad themes. I touch on some key issues from macroeconomics, from microeconomics, and from international economics which illustrate the synergism of the different parts of the book.

2. *Macroeconomic Policy*

Both the first policy chapter of the book and the first section of Feldstein's introduction are on monetary policy which is appropriate given the great importance of monetary policy in the decade. The major economic event was, of course, the reduction in inflation from the double digit levels of the 1970s, a process which resulted in the depressed economic conditions of the early 1980s. The changes in inflation are documented clearly in Michael Mussa's technical paper. In my view, several important aspects of monetary policy during this period are brought to light by the discussion stimulated by his paper.

A. *Monetary Policy: Stealth, Credit Controls, and Ronald Reagan*

The first concerns "the Federal Reserve's adoption of a more monetarist approach to policy-making in 1979" (Volcker, p. 145) under which the operating instrument of monetary policy was shifted from interest rates to the monetary aggregates. This major shift in policy, which occurred in October 1979—only two months after Volcker became Chair of the Fed, marked the beginning of the disinflation effort. Volcker describes the context for this shift: deteriorating confidence that the Fed would tighten sufficiently. Market participants, according to Volcker, had interpreted the most recent discount rate increase by the Fed as a weak response to inflation because the vote at the Federal Reserve Board was only four to three, even though Volcker knew he had enough votes for more increases.

At the time, many outside economists assumed that this change in monetary policy away from interest rates toward monetary aggregates was instituted at least partly as a "stealth tactic" in order to hide the Fed from criticism in case interest rates would rise very high. By setting money growth, the Fed could let interest rates rise as much as it needed to bring the demand and supply for money into balance. Thus, when criticized for very high interest rates, Fed officials could say "We do not set interest rates."

Yet, when asked about whether this change was a stealth tactic, even when pressed by Schultze who was CEA chairman at the time, "Volcker asserted strongly that applying monetarist theory had not been a stealth tactic" (discussion, p. 159). However, this is perhaps an area where some of the nuances of the discussions are hard to summarize. For example, at a later point in the discussion, Volcker emphasizes that the new procedures would never have been adopted if he or other FOMC members had anticipated interest rates rising so high. Importantly Volcker also notes that interest rate targeting usually has the disadvantage that interest rates will be adjusted too slowly—as they were in the 1970s—and expresses some concern about the switch back to interest rate targeting at the Fed under his successor Alan Greenspan.

Second, the discussion makes clear how the credit controls—which caused the short-lived 1980 recession—were imposed by the Fed under arm twisting by the Carter Administration—an imposition which Schultze has little sympathy for. Schultze explained that the reason the controls were wanted was that the "AFL-CIO was urging the [Carter Administration] to use the credit controls to reduce the flow of credit without raising interest rates." In other words, forces within the Administration succeeded in finding a way to prevent the Fed from raising interest rates further. This episode indicates to me that had the Carter Administration been given a second term it might have tried to persuade the Fed to cut short its disinflation effort during the tough years of 1981 and 1982. This brings me to my third point regarding monetary policy.

In analyzing the 1980s, many point out that Volcker was appointed to his position by Jimmy Carter, not by Reagan. This would seem to imply that had Reagan not been elected inflation would have come down and stayed down in any case. But Feldstein's discussion as well as Volcker's and Schultze's recollection of the credit control episode cast doubt on this conventional wisdom. Throughout the disinflation period, President Reagan did not criticize the Fed. In fact, according to Feldstein, despite urging from his staff and close congressional allies, Reagan decided that he would not interfere at all with the anti-inflation policy of the Fed, despite the deep 1981–82 recession and the impending congressional elections in 1982. In a meeting with one of these congressional allies Reagan, according to Feldstein, listened politely to the "plea to lean on the Fed to achieve an easier monetary policy, but then explained that would be wrong because it would jeopardize the progress on inflation" (p. 8). In fact lower money growth and lower inflation was one of the four policy principles of Reagan's program for economic recovery announced in 1980. The Feldstein-Volcker-Schultze discussions indicate a much greater role for Reagan in supporting Volcker's disinflation than is generally realized. Given that

the reduction in inflation is considered one of the major policy accomplishments of the 1980s, it would be a worthwhile to delve further into this important area of Federal Reserve-White House relations in the conduct of monetary policy during this period.

B. *Taxes, Spending, and the Budget Deficit*

If the decline in inflation is the most frequently mentioned gain from the economic policy of the 1980s, the most frequently mentioned criticism was the increase in the budget deficit. How large was the increase? As Poterba reports in his background paper, the full employment deficit rose as a share of GDP by 1.1 percentage points, from 1.6 percent of GDP on average in the 1970s to 2.7 percent of GDP on average in the 1980s. Put in these terms the increase in the budget deficit in the 1980s seems considerably less dramatic than conventional wisdom would have it: more than half was inherited from the 1970s. To be sure, as Poterba points out, the deficit should be measured in real terms, and with the decline in inflation in the 1980s the real deficit was higher for any given nominal deficit. Nevertheless, these numbers raise the puzzle of why so much emphasis has been placed on the budget deficit in assessing the policy of the 1980s.

An important historical question with implications for future policy is why did the deficit increase, or why did it not decline. The technical paper by Poterba, the discussion by David Stockman and the introductory paper by Feldstein make for some interesting reading on this question.

First, consider the behavior of taxes and spending. Poterba's paper shows that tax receipts as a share of GDP remained roughly constant during the 1980s equaling 18.9 percent of GDP in 1979 and 19.2 percent of GDP in 1989. Thus, as a matter of accounting one could say that the increase in the deficit during this period was due to spending increases, rather than to tax decreases. Of course, one could also say increased because taxes were not raised to cover the increased spending on defense and entitlement programs. Thus, whether lower taxes or higher spending "caused" the deficit depends on your perspective. The key question is why the deficit increased. Why weren't taxes increased more or why wasn't spending cut more? Did economic theory—for example Ricardian equivalence—play a role? Or was it optimistic economic forecasts, either due to technical errors or wishful thinking? Or was there another reason?

Feldstein and Stockman both explain the deficit increases as mainly due to wishful thinking. According to Feldstein, President Reagan either hoped that the deficit would decline as the economy grew or else thought that spending cuts would eventually be made. Hence, an increase in taxes as a share of GDP was not viewed as either necessary or desirable. Feldstein's essay describes his own conversation with Reagan:

> I recall that on one occasion I said to him that, while economic growth at 5 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" or "imprudent" was not a way of persuading Ronald Reagan. (p. 59)

Feldstein then goes on to explain that a person with the remarkable career of Ronald Reagan must have a mind set that makes the impossible seem possible. Feldsein also argues that the supply side argument that tax cuts would pay for themselves was a factor in the optimism. Here there is a disagreement over what influence this supply side view had. The analysis by Martin Anderson in *Revolution* (1988), his memoir on Reagan's economic policy, takes a different view from that of Feldstein. The influence of supply side economics on the Reagan tax cuts is still an unresolved issue worthy of continued historical research.

My view is that there was an overriding desire on the part of Reagan to keep tax receipts from *rising* as a share of GDP. His ultimate plea for the 1981 tax rate cut presented on national TV was that it would offset bracket creep as illustrated in a televised chart and keep taxes from rising. In this

argument, he was correct and noncontroversial. In the end the Reagan Administration was barely successful in keeping tax receipts from rising as a share of GDP, as Poterba's numbers show. With the absence of the 1981 tax cuts it would have failed in this goal.

3. *International Economic Policy*

Few of the writers and commentators in this book are very sympathetic with the idea of the international coordination of monetary and fiscal policy, an activity which increased dramatically in Reagan's second term. Feldstein notes that the most talked about success in international coordination—the Plaza Accord—actually had little to do with the decline in the dollar which had started several month earlier. He also argues that the effort to stabilize exchange rates under the Plaza Accord interfered with domestic monetary policy in Japan and the United States. I agree with his assessment that the exchange rate stabilization led to a monetary policy which was too easy in Japan in 1987 and 1988; it probably led to the boom and subsequent collapse in the 1990s. But I disagree that it also led to policies in the United States which were too tight. Indeed, in retrospect at least, monetary policy in 1986 and 1987 in the United States was probably too easy on average rather than too tight. The boom in the United States in 1987 and 1988 got too far out of control; it eventually led to a typical boom-bust cycle as the Fed needed to tighten to offset inflationary pressures in the 1988–89 period.

Volcker's comments on the Plaza Accord are particularly interesting in that he claims the Accord had no implication for U.S. monetary policy either explicit or implicit. Volcker says he was willing to go along with the agreement because he felt that Fed policy would not be tightened soon anyway. In other words, even if one does not like international macroeconomic coordination, the discussion between the finance ministers that define it may be quite benign in practice. Moreover, the opportunity to discuss related economic issues—whether a debt crisis, trade policy, or financial market regulation—may be a useful by-product of such discussions.

Regarding international trade policy, Richardson gives a somewhat negative assessment of trade policy during the Reagan Administration. "U.S. trade policy in the 1980s seems on balance to have become mildly more restrictive" (Richardson, p. 655). Clearly the expansion of voluntary restraint agreements, increased congressional activism (Super 301), and even managed trade as in the semiconductor agreement are not moves in the direction of free trade, and those who followed in the Bush Administration had to spend much of their time trying to mitigate, revise or dismantle these provisions.

However, the initiation of the Canadian-United States free trade agreement—though not the ideal multilateral approach—must on balance be considered a positive development. Although discussed only in passing in this book, the U.S.-Canadian free trade area, turned out to be the first step toward the North American Free Trade Agreement (NAFTA) started by George Bush and finished by Bill Clinton. Moreover, the Uruguay Round started during the Reagan Administration was taken up with enthusiasm by both the Bush and the Clinton Administrations. Recently passed by Congress in December 1994, it promises to reduce deadweight loss in the United States by many times the reduction due to NAFTA.

4. *Microeconomic Policy*

Four chapters of the book are on microeconomics: three on regulatory policy and one on antitrust. The background papers by Noll and Joskow document the decline in economic regulation—that is, government regulation of the price or entry of firms—with commentaries by Bailey and William Niskanen. The chapter by Viscusi focuses on social regulation—mostly in the health and safety areas. The juxtaposition of Joskow and Noll's chapter and Viscusi's chapter highlights the conflicting trends in these two areas in the 1970s and 1980s: increasing social regulation with inadequate attention to cost-benefit analysis and other economic considerations compared with decreasing economic regulation stimulated at least in part by economic arguments.

Given the fact that regulatory relief was one of the four key principles of Reagan's program for economic recovery, perhaps it comes as a surprise that all the writers and commentators in this book express major dissatisfaction with economic and social deregulation efforts in the 1980s. Noll and Joskow remind us that economic deregulation actually began in 1975 and was almost complete by the time Reagan became president, though the Reagan Administration prevented re-regulation.

On social regulation Viscusi presents examples of cases where existing new regulations on risk could never pass a simple cost-benefit analysis and he gives the Reagan Administration low marks for not pursuing a more effective regulatory reform approach in this area. He states: "A major failure of the Reagan regulatory reform effort is not just that such reforms were never achieved but that they were never attempted." DeMuth, who served as head of the group at the Office of Management and Budget which tried to implement cost-benefit analyses, considers several examples where the cost-benefit analysis was readily applied. He also describes how out of touch simple economic arguments such as "let the private sector do it unless there are externalities" seem in the area of health and safety regulation. He states

> these [economic] arguments which seemed highly persuasive to me and to the economists I was working with at OMB seemed strange and irrelevant not only to program officials at the Transportation department but also to political officials at the White House. (p. 509)

Areeda's background paper portrays the changes in antitrust policy during the 1980s as fundamental. He documents the sharp reduction in the legal staff at both the Justice Department and the FTC and illustrates with examples the increase in the use of economic arguments.

I found Baxter's recollections of his experience as head of the antitrust division to be one of the best (and the longest) "policy memoirs" in the book. He describes his strategy for changing policy in the antitrust division given the inherent interventionist mode of antitrust policy in the United States. He also describes his rational for the 1982 merger guidelines, including the ranges for the Herfindahl-Hirschman Index. Anyone interested in the application of economics to policy will benefit from a careful reading of his remarks.

5. *Conclusion: Watershed or Pendulum?*

Despite the many different views about policy in this book, two major themes are clearly discernable in my view. First, the book leaves little doubt that the 1980s was a decade of major change in economic policy in the United States, especially in the areas of inflation, tax policy, and antitrust policy. Certainly these policies represented a sharp policy break from the past. Compared with the years that preceded it, the decade of the 1980s had a lower-inflation monetary policy, lower marginal tax rates, and a less interventionist antitrust policy. On this point there is little disagreement among the contributors of this book, with debates mainly over when the changes began—in the late 1970s or the early 1980s.

The second broad theme relates to whether these changes in economic policy represent a watershed with the changes lasting into the future or simply a pendulum swing which will soon be reversed. Were the 1980s a watershed?

Because this book was published in 1994, beyond the end of the Reagan Administration and the Bush Administration and well into the Clinton Administration (though before the November 1994 Congressional elections), it is possible to make an assessment about whether the watershed view or the pendulum view is more accurate. If one takes the essays in this book as a description of what happened and if one looks carefully at what has happened since the end of the Reagan Administration, then it appears that the 1980s were more a watershed than a pendulum swing. As the United States moves beyond the 1980s, there are forces to reverse these policies of the 1980s, but they have not been fully successful. True, there are renewed concerns about inflation and some worry about a return to the 1970s inflation, but the Fed

tightening in 1994 was not nearly as delayed as the tightenings in the 1970s. True, marginal tax rates rose in 1990 and again in 1993, but they are still below the level of the 1970s. True, there was a re-regulation of cable TV, but there is general dissatisfaction among consumers about the rate changes that accompanied this move. True, there are signs of more interventionist antitrust enforcement, but the overall thrust of antitrust policy has not changed since the early 1980s, and the 1982 merger guidelines are not likely to be revised much in the near future. Moreover, there has been continuing progress in international trade policy. The general direction of trade policy, first under the Bush Administration and now under the Clinton Administration, has been to complete an FTA in North America and the GATT round.

In conclusion, even though one can criticize, as I have, certain views of policy and several serious omissions in this book, it provides a highly informative and professional analysis of economic policy in the 1980s in which two major themes emerge: (1) the 1980s were a decade of major change in economic policy in the United States and (2) most of these policy changes seem to be lasting as the 1980s recede into the past.

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