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The State of the Union

Implicit in President Reagan's "last hurrah" State of the Union address was the acknowledgment that, regardless of its genuine successes in promoting economic growth, his administration has largely failed to "get Government off the people's back" and has been only marginally successful in convincing the public that free-market policies are beneficial. Although their analysis is irreparably flawed, the view now gaining acceptance in trendy academic and political circles is that free markets "don't work." The policies of a coming generation of political advisors could quickly undo the accomplishments of the truncated "Reagan Revolution."

In his State of the Union address last week, President Reagan enumerated the key accomplishments of his administration, among them: the longest peacetime business expansion in American history; the reduction and simplification of personal income tax rates; an unparalleled record of growth in domestic employment; growth in family income; and bringing "inflation" under control. The President said that the Nation had experienced a complete turnabout, "a revolution that – at a critical moment in world history – reclaimed and restored the American dream."

Yet for all its inflated rhetoric, much of his speech addressed a major failure of his administration: namely, to control Government spending. Although he paid lip service to smaller Government in his speech, his proposals to abandon the present budget process in favor of a "simple partnership, a joint agreement" between the Executive branch and Congress and to empower a presidential line-item veto are far from his initial campaign pledge in 1980 to get Government "off the backs" of the American people.

Ronald Reagan was the first Republican president of the postwar period who promised a marked reduction in the role of the Federal Government. This was to be accomplished by deregulating enterprise and lowering tax *rates*. President Reagan intended to increase the resources devoted to national defense while holding total outlays constant, which implied reductions in other types of spending. Tax rates have been lowered, and many enterprises have been deregulated. But in evaluating Reagan's record, it is clear that the greatest failing has been the Federal deficit.

As shown in Chart 1, the deficit increased markedly during the 1981-82 recession. But unlike that prior episode, the deficit has remained at a very high level even after 5 years of expansion. In many quarters, this is attributed to the tax cuts enacted in 1981 and 1986. Sometimes these are referred to as "tax cuts for the rich," an assertion that is simply incorrect. Since 1981, "the rich" by any definition have paid not only more individual income taxes but also a larger share of such taxes. Even if this had not occurred, the number of persons subject to the top tax rate is small and the taxes collected from them have never been significant in comparison with total receipts or the deficit.

As shown in Chart 2, a sharply upward trend of tax re-

Chart 1
FEDERAL SURPLUS OR DEFICIT
The Federal deficit widened markedly as a percent of GNP during 1982 as a result of the recession then. However, the deficit did not narrow during most of the current business-cycle expansion, in contrast to prior recoveries. Despite a substantial reduction in FY1987, the deficit remains very large in comparison with prior years.

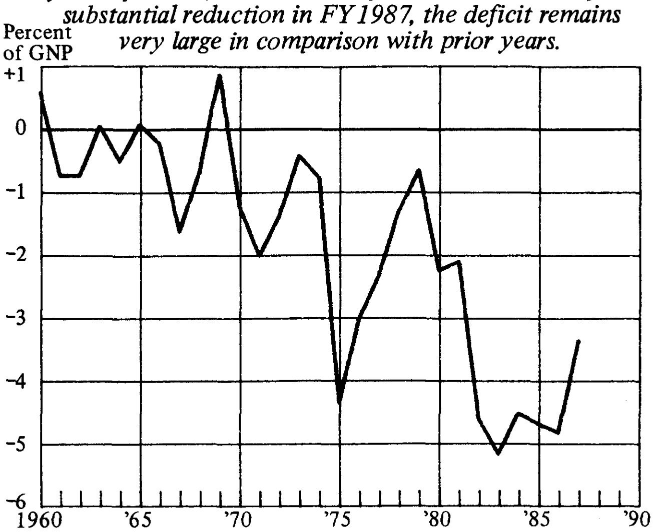
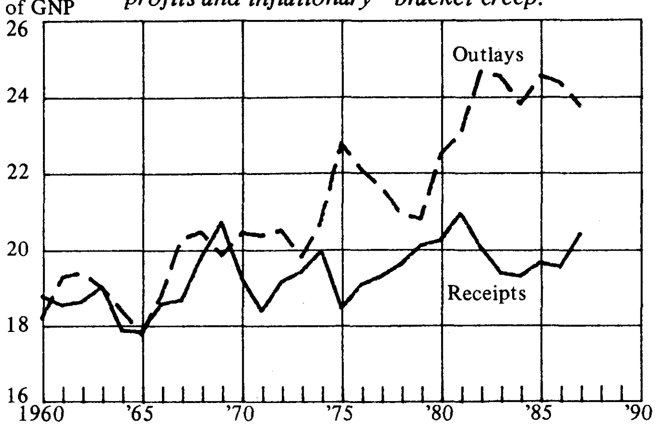


Chart 2
FEDERAL RECEIPTS AND OUTLAYS
Federal outlays, which skyrocketed between 1979 and 1981, have decreased little in relation to GNP during the current expansion. This accounts for recent large deficits far more than any tax reform induced "shortfall" in receipts, which in FY1987 reached a historically high level that was exceeded only in 1969 and 1981, when revenues were swollen by taxes on "phantom" inventory profits and inflationary "bracket creep."



ceipts *was* reversed in 1982, but this was mainly the result of the recession then. During the subsequent 3 years, tax receipts did not exhibit their prior "buoyancy," largely due to subdued price inflation, which stemmed "bracket creep" and made accelerated depreciation and other business deductions more valuable for tax purposes than the authors of the 1981 law had expected. Last year, however, tax receipts again surged following the 1986 tax reform, which further reduced tax rates but also eliminated many tax breaks.

In any event, it is likely that some sort of tax relief would have been enacted under any administration, given the trends of the preceding years. And it is unlikely that total receipts would have been markedly higher in relation to GNP. The level of Federal receipts during recent years was exceeded only during periods when the economy was "overheated" and entering recession. Recent levels of Federal receipts have not been "low."

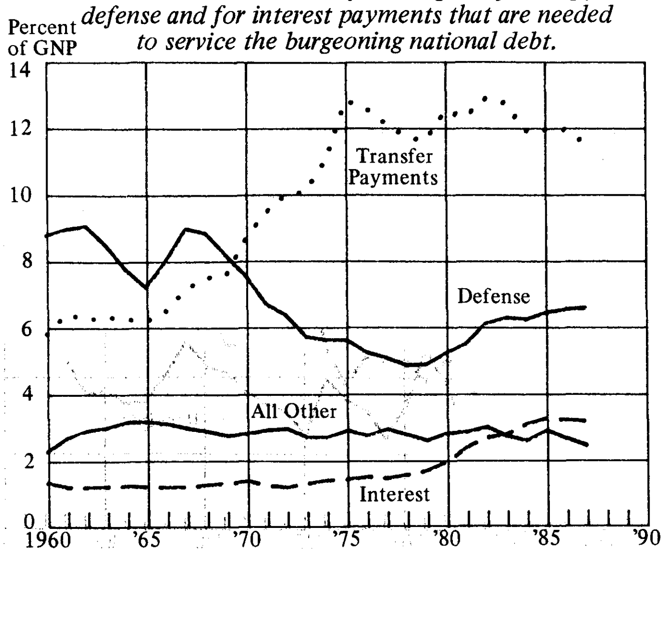
Rather, as is evident in Chart 2, unprecedented Federal outlays during the 1980's produced the massive deficits. Chart 3 shows Federal outlays broken down by function. As this chart shows, it has been outlays for defense and for interest that recently have increased more rapidly than GNP. Although their relative level is nearly double that of 20 years ago, fluctuations in transfer payments under President Reagan have been small.

The point is that it has been *high spending* that has kept the deficit high. In many instances Congress has forced unwanted programs on the Administration by including them in "must sign" legislation (as in the 43-pound "resolution" submitted to him last Christmas, which included the now-infamous appropriations for cranberry, blueberry, and wildflower research). The most distressing aspect of the budget deficits has been their cumulative effect on interest outlays. As long as the level of the national debt continues to grow more rapidly than GNP, interest will continue to absorb an increasing proportion of the budget, eventually leaving officials little recourse other than to inflate away the value of the debt. In short, on balance it would appear that Ronald Reagan may go down as simply a "hold the line" Republican president. What is more ominous, that "line" may be weaker than many suppose.

Chart 3

FEDERAL OUTLAYS BY FUNCTION

Transfer payments, which are by far the largest Federal expenditure, have fluctuated cyclically around 12 percent of GNP since 1976. Government outlays for all other expenses but defense and interest payments have changed little since 1960. The increase in Federal outlays in relation to GNP thus reflects higher spending for defense and for interest payments that are needed to service the burgeoning national debt.



Beware the "New Keynesian Mainstream"

Except for some relatively minor programs and for elements of "waste, fraud, and abuse," the Administration *never* proposed major cuts in domestic spending. Social Security payments, which are the largest single item in the Federal budget, were declared "off limits" to the budget cutters. Administration policy initially was to keep total domestic spending constant in real terms, with the hope that economic growth, spurred by supply-side policies, would reduce its relative importance, and generate additional tax revenues to finance a stronger defense and to reduce the deficit. Obviously, this did not occur. Congress rejected most limitations on domestic spending and such outlays have continued to expand with the economy. Middle-class entitlements apparently now are irrevocable. Perhaps more significant, the burgeoning deficit today is widely perceived by a new breed of would-be presidential and Congressional consultants to be the result not of a failure to curb spending, but rather as a deficiency of the "supply side" and monetarist policies advocated by the Reagan Administration.

According to this line of thinking, during the Reagan years "supply side" notions have been shown to be wrong at every turn: despite allegedly "huge" tax cuts, the economy's performance has fallen far short of supply-siders' predictions; despite unprecedented increases in the money supply, "inflation" has remained subdued; and "Reagan's huge tax reductions of 1981 did little to boost productivity or induce Americans to put their extra pennies in the bank; saving rates plummeted in 1985 and 1986, hitting postwar lows after personal tax rates were slashed the next year." In the words of one admirer of this "network of thoughtful young economists" (collectively dubbed the "New Keynesian Mainstream"), the net result of supply-side economics has been "A skimpy 2.4 percent-a-year growth rate since 1981 – less than any previous decade since World War II."*

Their analysis is highly misleading. Although economic growth *has* been somewhat below the long-term U.S. average since President Reagan took office, that reflects the impact of the 1981-82 recession. Economic growth in the United States has been better than in most of the industrialized world during the past 5 years. Moreover, the 1981 tax law was at most a timid implementation of "supply side" policy.

Concurrent large increases in the Social Security tax rates and in maximum income taxable to Social Security resulted in tax increases that offset reductions in personal income tax rates (between 1980 and 1987, the combined employer-employee maximum Social Security tax *more than doubled*). In short, combined taxes for most individuals probably changed little – and if "contributions" to social insurance are included in personal savings, as they are in other countries' calculations of savings rates, then those rates actually increased substantially during the Reagan years. The corporate tax rate was cut in 1986, but at the same time many tax deductions and credits were eliminated.

As for the notion that the current disinflation defies any supposed relationship between monetary inflating and price levels, we have observed elsewhere that Paul Volcker's flaunted success in "beating inflation" seems to have depended largely on his ability to convince the Nation, and the world, that the Fed had become less willing to succumb

* See Robert J. Shapiro's "Look Who's Making a Comeback [John Maynard Keynes–Ed.]," *U.S. News & World Report*, February 1, 1988, pp. 43-45.

to the inflationary biases of the system by allowing interest rates to increase to levels that his predecessors deemed "unthinkable." In fact, inflationary distortions have continued to accumulate in the economy, and strongly suggest that accelerating price inflation lies at some point ahead.*

Based on their distorted view that free market, sound money policies have been proved "less resilient than Keynes's tried-and-true theories," the New Keynesians nevertheless propose to revive virtually all of the failed tax-and-spend policies of the past. On their agenda are hikes in income taxes, especially for "the rich"; an "easier" monetary policy; restoration of the tax breaks eliminated by the Tax Act of 1986; a new levy on interest earned by foreigners on their U.S. deposits; massive new jobs programs designed along the lines of New Deal public works projects; and, despite the disastrous record of centrally planned attempts to stimulate economic growth in Third World countries during the 1970's, the expansion of direct subsidies for foreign purchases of U.S. goods and services. These policies, it is said, will "boost creativity," create jobs, and wipe out the deficit.

As the positive American and foreign business response to the limited free-market reforms of the Reagan program may suggest, people who run businesses and seek sound investment opportunities apparently thirst for and are ready to act on even the smallest sign that a region or country is attempting to foster a favorable, *i.e.*, freer, business climate. We have remarked on many occasions that capital has flowed in such great quantities into the United States during the Reagan years largely because, in comparison with the alternatives (Argentina? Brazil? Zimbabwe?), business conditions here are perceived as being highly advantageous.

We also have observed that business activity contracts and capital flees when conditions become unfavorable. So far as business perceptions are concerned, the danger today is that the truncated – indeed, scarcely begun – free-market Reagan "revolution" may be widely viewed by the public and by those in power as a "failure," and that they will once again opt for the stifling policies of the past, no matter how they are dressed up to appear new and different.

It is doubly ironic that America now seems poised to turn away from the further liberalization of its economic and social institutions. This is happening just as people in much of the rest of the world – from Europe to Asia, Africa, and Latin America – appear to be yearning for the benefits of economic freedom and democracy that they have seen unfold on our own shores.

* See *Research Reports*, June 15, 1987 and January 4, 1988.

UNINTENDED CONSEQUENCES: ERISA AND THE STOCK MARKET

That government intervention to solve a particular economic problem invariably creates costs and difficulties elsewhere in the economy is well accepted in theory, if not in practice – perhaps because the consequences of intervention often are subtle and difficult to identify in advance. An interesting example is how "reforms" designed to make workers' pensions more secure have created a significant link between common stock prices and corporate earnings. Because common stock prices are believed, in part, to reflect earnings, this "positive feedback loop" can be expected to destabilize financial markets.

The goal of virtually every government regulation and intervention into economic life is to make it more stable and/or more secure. For much of history, government policies were plainly designed to favor specific groups, such as landlords, guild members, holders of royal monopolies, *et al.* Today, most students of economics understand that practices such as price or production controls, licensure, tariffs, officially supported monopolies, etc., provide concentrated benefits to special interests that are much smaller in aggregate than their costs, which are diffused among the general public. This is not to say that such practices have been abandoned. All too often the public remains apathetic, and the special interests are able to prevail upon the politicians.

Nevertheless, compared to much of the past, and to much of the world today, U.S. producers and consumers have a high degree of freedom in their "microeconomic" decisions regarding what and where to buy, what and how to produce, etc. Nowadays, in the United States and most industrialized countries, traditional policies designed to protect producers from competition are greatly overshadowed in significance by government intervention in the form of direct payments to or on behalf of individuals to maintain their incomes and ability to consume.

"Transfer payments," defined as any payment made in cash or kind on some basis other than current contributions to output, are the foundation of the modern "welfare state."* These in turn have been facilitated by levels of taxation (including the "hidden tax" of inflating) that, in historical perspective, can only be described as breathtaking. For example, considering only Social Security taxes, income taxes, and unemployment taxes (but no other "fringe benefits"), even a low-paid worker can cost an employer 50 percent more than the amount of the employee's paycheck.

There can be little doubt that the welfare state's transfers of income are far more pervasive than those from more ancient forms of government intervention. But transfer payments are little different in their results, if not in magnitude, from, say, a protective tariff – they both make one group better off at the expense of another.

It may be argued that the welfare state is *qualitatively* different from earlier interventionist systems. Neither its benefactors nor its beneficiaries are fixed but rather they are determined by individual circumstances. The notion is that the welfare state is not a reflection of special privilege, political power, or outright tyranny. (This might be disputed by anyone who has attempted to reason with an "advocate" for the elderly such as Rep. Claude Pepper.) Whether or not this argument has merit, it is clear that the level of benefits and eligibility requirements are the result of the political process rather than of economics or the marketplace.

There is another aspect of the welfare state that was seldom addressed by earlier interventionists: that transfer payments serve to stabilize the economy to everyone's benefit. Indeed, it is part of the conventional wisdom that government transfer payments serve to maintain purchasing power and demand during economic downturns, thereby moderating the business cycle. Transfer payments tend to increase during contractions of economic activity, as more people apply for benefits. Progressive tax rate schedules and taxation of corporate profits, which are highly cyclical, result in government receipts decreasing more rapidly than economic activity during contractions. Falling tax receipts and higher transfer payments at such times mean that government deficits soar, thereby providing the economy with what are often called "automatic stabilizers."

These automatic stabilizers probably do serve to provide the "macroeconomic" benefit of forestalling another downward spiral of contracting demand, bankruptcies, and prices

* It is one of the greatest, and least appreciated, ironies of the 20th century that the Marxian principle of "from each according to ability, to each according to need" is more nearly approximated in the industrialized countries of the West than in the Soviet Bloc.

comparable to the Great Depression of the 1930's, especially under a regime of fiat currency. An episode of contracting output and employment similar to the Great Depression would, in today's circumstances, be far more likely to reflect a flight from currency, in which real demand collapses because people reject the official medium of exchange. However, the automatic stabilizers themselves foster the condition, chronic inflating, that has throughout history led to a flight from currency.

The purpose of the foregoing rather lengthy discussion is to show that government cannot intervene in economic life to "solve" some problem, large or small, without consequences that reach beyond the problem that the intervention is attempting to address. As Milton Friedman puts it: "there is no such thing as a free lunch." The difficulty is that the unintended and generally adverse consequences of intervening are often subtle and not easy to foresee.

Pension Reform's Effects

An interesting example of this is the Employee Retirement Income Security Act of 1974 (ERISA), which was designed to ensure that workers would receive the pensions that they expected from employer-sponsored pension plans. From the time of its enactment we have focused (most recently in *Research Reports* for October 19, 1987) on the likelihood that ERISA's rules would prompt many employers to cease to offer pension plans and on difficulties with the Pension Benefit Guarantee Corporation (PBGC), created under ERISA to assure payments of employees' "vested" benefits from plans that are terminated, usually (but not always) when their sponsors become bankrupt.

The PBGC is financed by "insurance premiums" assessed on companies with pension plans. These costs, and the deficit of the PBGC, have soared as the PBGC has been forced to take over the unfunded obligations of the pension plans of bankrupt and reorganized companies in declining industries. In addition, ERISA's rules have encouraged the termination of many healthy pension plans, eliminating many current workers' future pensions, as the sponsoring companies have been tempted to recover excess assets (mainly the result of soaring stock and bond prices) in the plans by ending them, paying out the present value of vested benefits to workers, while keeping the remaining funds.

ERISA's funding rules apply only to "defined benefit" plans, rather than "defined contribution" plans. Like Individual Retirement Accounts (IRAs), the latter differ from ordinary savings for retirement only in their tax treatment – payments into IRAs and defined contribution plans and income earned on their assets are not taxed as income, but all payments out are deemed to be income. In contrast, ordinary savings must be made out of after-tax income, and earnings on accumulated savings are taxed immediately, but withdrawals are not taxed.

Under conditions of chronic and variable inflating the problems of managing a defined benefit pension plan are acute. They involve projecting the future level of benefits, the rate of return on future earnings, etc. Changing assumptions regarding future price, wage, and benefit levels and varying rates of return on a plan's assets result (at a minimum) in considerable variation in the amount of the annual contribution needed to make a company's plan solvent.

Actuaries, accountants, and indeed ERISA's rules, tend to employ devices, such as moving averages, gradual changes in assumptions of future trends, and long periods for amortizing unfunded liabilities, that serve to moderate fluctuations in the annual amounts that a plan's sponsor must pay in. There is one major exception: employers are not allowed to deduct as an expense on their tax returns – and ERISA's rules proscribe – any contributions to plans that are "fully funded."

The total effect of these rules and practices on annual pension costs is extraordinarily complex and difficult to measure, but it is clear that employers' payments into pension plans have "leveled off" in recent years, and have actually decreased markedly in relation to wages. Since 1983, payments out of plans to beneficiaries actually have exceeded payments in by employers. The reason, of course, was that the assets held in pension plans, especially common stocks, have appreciated markedly since 1982.

Writing in the *New England Economic Review*,* Alicia Munnell has estimated that the "bull market" in securities prices subsequent to 1982 caused corporate pension expenses to be $30 billion less in 1986 than they would otherwise have been. This has subtle implications.

First, because employer contributions to pension plans are counted as part of the "compensation of employees" in the National Income and Product Accounts (NIPAs), the "missing" $30 billion reduced the estimate of personal savings by that amount and the widely followed personal savings rate by a full percentage point. Secondly, Ms. Munnell estimated that the reduction in pension costs resulting from higher securities prices reduced the rate of increase in the indexes of hourly earnings and employment costs by "roughly two-tenths" of 1 percent per year during the 1980's.

Finally, and perhaps most significantly, the $30 billion that employers did not contribute to pensions in 1986, as a result of the stock market boom, was added to pre-tax corporate profits then. Because the aggregate data are derived from the NIPAs and, for a variety of reasons, may not match up with the aggregate of corporations' published financial results, estimating the impact of this $30 billion is difficult. But, it would appear that about $12 billion was paid to the Treasury in higher tax payments and the remaining $18 flowed through to the "bottom line" reported to stockholders. *That amount would represent roughly one-third of the increase in corporate after-tax profits between 1982 and 1986.*

To an unknown extent this addition to corporate profits served to boost stock prices to higher peaks than they would have reached if pension costs had maintained their prior trend. The mechanism could be reversed. Ms. Munnell notes that "a decline in the stock market should create a substantial increase in pension contributions." If so, this could exacerbate the downward cycle of stock prices as well by depressing corporate earnings.

In short, the politicians' efforts to create the security of assured fixed pensions may have created a giant engine for instability in the financial markets. Making corporate profits significantly dependent on the level of stock prices greatly increases the uncertainties of saving and investing for retirement or any other purpose.

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* Nov./Dec. 1987, published by the Federal Reserve Bank of Boston.

PRICE OF GOLD

	1987	*1988*	
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