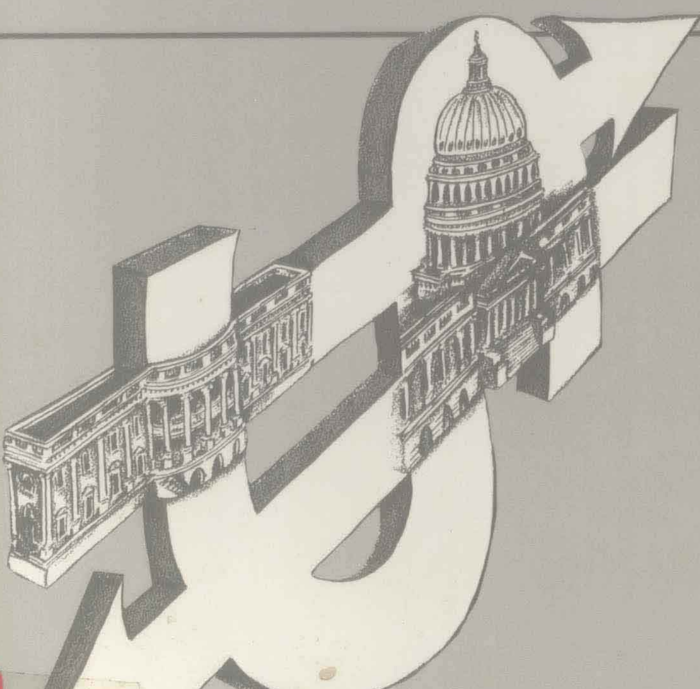
Politics and Economics in the Eighties



Edited by

ALBERTO ALESINA and GEOFFREY CARLINER

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Preface

We have tried to accomplish something unusual in this volume: an interdisciplinary analysis of economic policy-making that balances new empirical research with a coherent review of the most important policy changes that occurred in the eighties. Our experience in organizing the conference and editing the book suggests that this volume may generate more passionate reactions than other NBER volumes for several reasons.

First, most of us who lived through the 1980s in America are likely to have strong views on taxes, welfare spending, budget deficits, the savings and loan debacle, and other aspects of the decade's economic policy. Many readers will probably disagree with the arguments or the emphasis of some of the papers. However, these readers may find themselves in agreement with the comments on the papers, which sometimes offer dissenting views. In our introduction, we tried both to summarize the basic arguments of each paper and comment and to offer our own point of view.

Second, this book is interdisciplinary: leading political scientists have written the papers, and leading economists have written comments. We believe that it is important to have both disciplines represented in a study of economic policy-making. The economists bring a deeper understanding of the significance of changes in these policies and their effects on the economy. The political scientists bring a deeper knowledge and understanding of the political institutions and forces that led to these changes. Especially in this area, we think that the strengths of the two disciplines are an essential complement of each other.

The background, language, modeling strategy, and choice of emphasis are often quite different between the two disciplines. Therefore, we asked the participants in this project to write for a wide audience, which includes both members of the two disciplines and a wider public of interested readers.

Finally, these papers include descriptions and explanations of the most important policy changes that occurred in the eighties, along with some technical modeling and hypothesis testing. Different authors have chosen different combinations of these ingredients. We hope that readers who are familiar with the policy changes in the eighties will find enough in the way of new research results, and that readers looking for descriptions and explanations of policy developments will not be put off by the technical sections of the papers.

We would like to thank the Andrew Mellon Foundation for financial support. Kirsten Foss Davis and Ilana Hardesty made sure that the conference went smoothly, and Mark Fitz-Patrick helped prepare the manuscript for publication. We would especially like to thank Candace Morrissey for her assistance in the entire process.

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Introduction

Alberto Alesina and Geoffrey Carliner

When Ronald Reagan won the presidential election of 1980 and the Republicans gained control of the Senate for the first time since 1954, did American voters reject past policies and indicate a permanent shift to the right? Or was the 1980 election a predictable response to the perceived mismanagement of the economy in the late seventies with no long-run implications? Did the economic policies that were adopted during the 1980s reflect a long-term shift toward conservatism, or were they merely extensions of past policies with, at most, a short-lived shift to the right during the two years (1981–82) when Republicans had effective control of the White House and Congress? More generally, how did politics influence the economic policy decisions in the 1980s?

The eight chapters included in this volume examine the evidence. They study voting patterns, monetary and fiscal policies, welfare spending, tax reform, minimum-wage legislation, the savings and loan debacle, and international trade policy. Taken together, they indicate that a sharp temporary shift to the right followed the 1980 election, as evidenced by the policies adopted during the early years of the first Reagan administration. Subsequently, the Democratic gains in the congressional elections of 1982, 1984, and especially 1986, contributed to moderate the administration's policies.

Voting

Morris P. Fiorina's analysis of voting patterns in the 1980s supports this view. He notes that Jimmy Carter faced the 1980 election with double digit

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inflation and a stagnant economy. Carter probably would have lost in 1980 on economic issues alone, even leaving aside the problem of the hostages held by Iran. In fact, several studies of previous elections have emphasized that slow growth and (to a lesser extent) high inflation significantly hurt incumbent presidents.[1] Thus, Carter's defeat does not imply a sharp realignment of the electorate toward the right.

The Democrats' loss of the Senate in 1980 was more unusual than their loss of the presidency, but again, it was a reaction to the specific events of the late 1970s rather than the result of a long-term shift in party allegiance. In fact, the large number of Republican victories in the Senate was not repeated in subsequent elections. In particular, the elections of 1982 and 1986 continued the pattern of midterm voting cycles in which the party holding the White House loses votes and seats in Congress. The presidential elections of 1984 and 1988 are also consistent with historical patterns. Reagan's reelection and Bush's victory confirm that voters favor incumbents and look at the rate of change in income and in prices in the election year when choosing presidents.[2]

In summary, Fiorina finds that the election results of the 1980s can be largely explained by the short-run performance of the economy in election years, and by the midterm cycle. In his comments to this paper, William D. Nordhaus notes that the apparent popularity of Republicans and their grip on the presidency could evaporate at the first reappearance of recession or inflation.

However, Fiorina also reports a longer-term shift in voters' attitudes in favor of the Republican party, especially in the upper middle class. The percentage of voters who identified themselves as Republicans in surveys rose from about 33 percent in 1962–82 to about 40 percent in 1984–88. Measures of party identification are obtained by asking voters in surveys whether they perceive themselves as Democrats (weakly or strongly), Republicans (weakly or strongly), or independents. Party identification reflects the voter's ideological bias in favor of a party and is influenced by several economic and noneconomic factors. Thus, voters may identify themselves as Democrats, even if they occasionally vote for a Republican candidate: party identification reflects long-run attitudes of the electorate and may differ from the actual voting behavior in each election. For instance, Jimmy Carter in 1980 was defeated when many voters who identified themselves as Democrats voted for Ronald Reagan as a reaction to Carter's perceived failures. Fiorina's results suggests that some of these voters may now consider themselves "permanently" Republican.

Voting in the eighties, particularly in the second half, also confirms a pattern that is becoming increasingly common in American political history: divided government—that is, a situation in which the same party does not control the presidency, the House, and the Senate. One explanation, formalized elsewhere by Fiorina and others, suggests that divided government is the result of a conscious attempt by the voters to achieve moderate policy.[3] According to this view, the American electorate has to choose between two parties that offer different policy options. Voters in the middle of the political spectrum desire policies in between those advocated by the median members of the two parties. These voters may prefer divided government rather than unified government: if different parties hold the presidency and Congress, they balance each other, and the resulting policy outcome is more centrist than would be with a unified government.

This desire for moderation may explain both split-ticket voting when Presidential and Congressional elections are held simultaneously, and the mid-term voting cycle. Both phenomena occurred in the 1980s; in this respect the last decade was far from unusual. In fact, a recurring theme of this book is the constraint placed on the ability of the Reagan administration to pursue conservative policies after the 1982 elections increased Democratic strength in the House, and especially after the Democratic party regained the majority in the Senate after the 1986 mid-term elections.

Monetary Policy

James E. Alt's study in this volume of monetary policy in the 1980s also emphasizes the importance of the balance of power between Congress and the president. He suggests that the Federal Reserve can be viewed as an agent with three principals: the president, Congress, and the financial community. The chairman of the Federal Reserve has a certain amount of independence, which he wants to preserve for himself and for the institution. Alt emphasizes that an agent with multiple principals enjoys a fair amount of autonomy when the principals disagree, which may be the case when the presidency and Congress are held by different parties. In addition to the goal of independence, Fed chairmen may want to enhance their chances of reappointment. Alt examines how different politicoeconomic models can explain the Fed's behavior, given this principal-agent relationship and the chairmen's goals of independence and reappointment.

Earlier studies have suggested two explanations for political influence over monetary policy. The first suggests that Democratic administrations are more expansionary than Republican administrations because the former care relatively more about unemployment (and less about inflation) than the latter.[4] The second emphasizes that presidents are almost exclusively concerned with reelection and thus engage in preelectoral manipulations of monetary policy to boost growth.[5]

Alt blends these two approaches by arguing that, at the beginning of a new administration, Fed chairmen tend to accommodate the president's partisan goals. When an election approaches, the Fed tends to follow a prudent course of action for two reasons. On one hand, the Fed wants to avoid preelectoral contractions in order not to jeopardize the incumbent's performance at the polls. On the other hand, the Fed avoids policies that are too clearly expansionary and thus favorable to the incumbent. In fact, the Fed wants to preserve its reputation for independence and avoid displeasing the challenger who, after all, may be the next president. Finally, the Fed may need to balance these political influences with the financial community's preference for stability in financial markets.

Monetary policy in the eighties was largely consistent with traditional Fed behavior, as described by these models. By 1979, inflation was perceived as the most serious economic problem, and the Carter administration and the Federal Reserve were held at least partly responsible for it. In the fall of 1979, one year before the presidential elections of 1980, Carter needed to support anti-inflationary policies to avoid losing control of the economy and of the election.[6] Therefore, he appointed Paul Volcker as chairman of the Fed, who immediately shifted monetary policy to target the money supply instead of interest rates and began to slow the growth of the money supply to reduce inflation.

In 1981 and 1982, with a new Republican president and a conservative Congress, the Fed received full political support for its tough, anti-inflationary policy. In these years, the United States experienced the deepest recession since the thirties, but inflation was quickly reduced. The weak Democratic contingent in Congress could do little to oppose this course of action.

In the summer of 1982, the Fed loosened its policy and started to rely less on monetary targeting. This change of policy can be explained by the feeling that inflation had been reduced substantially and the economy needed help to recover. Also the threat of financial crises due to the less developed countries' (LDCs') debt problem and the difficulties of the savings and loan institutions (S&Ls) may have influenced the Fed's decision. After 1982, Democratic gains in Congress reduced the political support for further anti-inflationary policies.

In his comments on Alt's paper, Benjamin M. Friedman notes that the Fed decreased its reliance on monetary targeting after 1982 because of the collapse of the relation between money growth and the growth of nominal income. In addition, Friedman emphasizes how the Fed's independence is enhanced not only by the multiplicity of principals, but also by the fact that each of the principals (Congress, the administration, and the financial community) may not have homogeneous preferences.

Fiscal Policy: Taxing, Spending, and the Deficit

Some of the most dramatic changes in economic policy during the 1980s involved fiscal policy, particularly in the first two years of the Republican administration. Military spending grew substantially, many social programs were cut back; tax rates fell sharply and the federal budget deficit soared. Some of these policies reflect traditional Republican views; in addition, some of these changes, like an increase in military spending, were initiated at the end of the Carter administration. However, Reagan's fiscal policies in

1981–82 viewed together represent a substantial departure from the seventies, including previous Republican presidents.

One dramatic piece of evidence of Reagan's departure from previous fiscal policy is the budget deficit. The most economically relevant measure of accumulated deficits is the debt/GNP ratio. This ratio shows a downward trend in the post–World War II period. Starting from a peak of 1.17 in 1945, this ratio was 0.23 in 1980. The large deficits in the eighties clearly reversed this trend: the debt/GNP ratio was 0.35 in 1985 and about 0.30 in 1989.[7] The deficit's share of GNP peaked at 6.3 percent in 1983, and then fell gradually for the next six years, particularly after the defense buildup slowed after 1986. By 1989, the deficit was 2.9 percent of GNP, about its share of output at the beginning of the decade.

Republican presidents traditionally have vigorously opposed budget deficits. In contrast, Reagan spoke out most strongly against tax increases and used his political power to oppose legislation that would raise tax rates and revenue, even if that opposition meant continued high deficits. Congressional Democrats, traditionally less concerned with deficits than Republican presidents, refused to cut spending, even though that also meant high deficits.

Mathew D. McCubbins in his contribution to this volume suggests that the increase in budget deficits was the result of "divided government," particularly of the control of the Senate and the House by different parties. He suggests that such divided control leads to fiscal deadlocks and prisoners' dilemmas, which resulted in spending in excess of tax revenues. Republicans and Democrats in Congress favor different spending programs. If the two legislative branches are controlled by different parties, they reconcile their differences by increasing spending on both parties' favored programs. The result is higher spending than would occur if either party had undivided control of the legislature.

A different explanation is that the large deficits in the early eighties were the result of miscalculations.[8] First the supply-siders in the administration vastly overestimated the incentive effects of the 1981 tax cut. Second, the recession of 1982 turned out to be the worst in post–World War II history and worse than was predicted. Third, inflation fell faster than anticipated, further decreasing revenues below their expected levels. The indexation of the individual income tax, which took effect in 1985, permanently eliminated the automatic source of increased revenues brought by inflation. When revenues fell sharply below planned expenditures, political and legislative inertia and the combined effects of various pressure groups made it difficult to correct the mistake. That is, politically costly decisions needed to stop the growth of the debt were postponed because of the difficulty of reaching a compromise over budget cuts or tax increases of the size needed to balance the budget.

A third political explanation, which does not rely on large miscalculations, is that the debt accumulation of the early eighties was a strategic attempt by the Reagan administration to constrain spending by future Democratic Congresses or future Democratic presidents. By creating large deficits whose effects would persist after the Republicans lost control of the Senate, the Reagan administration reduced the flexibility available to Democratic legislators to increase nonmilitary spending. With a large deficit and a rapidly increasing interest bill, it is difficult to justify major increases in spending programs, particularly if tax increases are viewed as economically and politically costly. Thus, the debt is the legacy of the Reagan administration to the future.[9] According to this argument, Reagan accepted large deficits because he was more committed to a reallocation of spending priorities than previous Republican presidents.

In his comments on McCubbins, Robert J. Barro argues that a large part of the history of the U.S. budget can be explained by the tax-smoothing model.[10] This theory suggests that it is optimal to finance unusual increases in spending, such as those occurring during wars or severe recessions, primarily with debt rather than with tax revenues. Smooth tax revenues and fluctuating deficits (and surpluses) distort the economy less than balanced budgets and fluctuating taxes. Indeed this theory is broadly consistent with the steady decline, with minor deviations for recessions and local wars, in the ratio of debt to GNP since its peak at the end of World War II.

Whether or not the tax-smoothing model explains the deficits in the 1980s is debatable: the debt/GNP ratio almost doubled in a decade without major wars. The military buildup of the eighties can be viewed as once-and-for-all effort to win the Cold War, for which it would have been optimal to run temporary deficits. The collapse of the Soviet bloc lends some support to this view, but recent events in Eastern Europe have deeper roots than the American military buildup. Furthermore, increased military spending accounts for only a fraction of the increase in the deficit. The tax cut of 1981 played a larger role: the tax-smoothing model may explain why deficits may have grown to finance the military buildup in a cold war period, but it cannot explain why taxes were cut.

One of the recurrent themes in these explanations of the deficits is the politicoeconomic struggle over allocation of government expenditure to domestic versus defense programs. Thus, it is important to analyze whether this allocation has substantially changed in the eighties. Although the military buildup was a major theme in Reagan's agenda, the buildup was in fact started by President Carter. Military spending in real terms fell steadily from 9.6 percent of GNP in 1968 to 4.8 percent of GNP in 1977. After two years of constant real spending, military spending increased in response to the Soviet invasion of Afghanistan. The Reagan administration sharply accelerated this buildup by raising military spending from 5.3 percent of GNP in 1981 to 6.5 percent in 1986, when Democrats regained control of Congress and ended the increases. By the end of the decade, before the startling events of the fall of 1989, military spending had fallen to less than 6 percent of GNP.

The military buildup was accompanied by reduction of spending in various social programs, particularly in the first half of the first Reagan administration. As John A. Ferejohn observes in his contribution to this volume, the programs that were cut the most or eliminated entirely, were those narrowly directed at the poor, such as CETA, Job Corps, Head Start, and other education programs. Spending on broadly based social insurance programs that benefited primarily the middle-class elderly, such as Social Security and Medicare, continued to grow untouched during the 1980s.

Ferejohn attributes this difference in treatment to the structure of the legislative process. He argues that the structure of Congressional committees insulated middle-class programs from attacks; thus, advocates of those programs could resist administration pressure for cuts more effectively than could supporters of programs beneficial to the poor. Ferejohn also notes that the administration, to a certain extent, managed to circumvent congressional opposition by tightening eligibility standards administratively. In addition to congressional committees, the pressure of public opinion created great obstacles to any attempt of reducing Social Security benefits. There was no similar outcry of voters when the administration proposed cutting poverty programs.

Ferejohn observes that, after the high water mark of Republican power in 1981–82, Democrats resisted further cuts in social programs. Even before they regained control of the Senate in 1986, they were able to stop further efforts by the Reagan administration to change federal spending patterns. He concludes the social spending cuts of Reagan administration were less widespread than commonly perceived and concentrated in a two-year period. Ferejohn also emphasizes the importance of the Congressional committee structure in protecting middle-class programs from further cuts advocated by the administration.

It is interesting to note that once the Democrats regained control of Congress, they made few attempts to introduce new poverty programs or to return existing ones to their former size. In part, this may have been due to the constraints in spending imposed by the accumulated deficits of the eighties. On the other hand, it may indicate a changing attitude: American voters and politicians were willing to support such spending under both Republican and Democratic presidents from the early 1960s until 1980, but during the 1980s this support diminished. This is in sharp contrast to the continued strong support for middle-class entitlement programs, which remained essentially untouched throughout the decade.

Tax policy also underwent substantial and frequent change during the 1980s. Although the changes that were passed into law, and the debates associated with them, reflect the traditional views of Republicans and Democrats, the emphasis of the Reagan administration was somewhat different from those of Eisenhower, Nixon, and Ford.

Charles H. Stewart III, in his contribution to this volume, describes the major tax changes that occurred during the decade. The largest was the Economic Recovery Tax Act of 1981 (ERTA), passed in the first months of the new administration at the peak of Reagan's power. ERTA cut marginal tax rates, substantially increased tax incentives for corporate investment, and indexed the personal income tax for inflation.

The following year, Congress had second thoughts about the size of the 1981 tax cut, and repealed many of the business tax incentives that had been introduced in ERTA. Excise taxes on cigarettes and telephone calls were also raised. Then, in 1983, taxes were raised again, as new federal employees were subject to the Social Security payroll tax, and the payroll tax rate and the maximum income subject to this tax were increased. Finally, the 1986 Tax Reform Act (TRA) continued the trend to lower marginal tax rates but eliminated many of the tax incentives for business investment that had been favored by Republicans for many years. For instance, the 1986 reform eliminated the investment tax credit and raised the maximum tax on capital gains from 20 percent to 28 percent. TRA was designed to be revenue neutral: its significantly reduced personal income tax revenues and offset this loss with increased corporate income tax receipts.

The end result of all this legislation was a major change in the structure of federal taxation. The marginal tax rate on the highest income bracket fell from 70 to 28 percent, many low-income individuals were dropped from the income tax roles, payroll tax rates and ceilings rose, some personal income tax deductions were scaled back, and many corporate tax benefits were eliminated.

A recurring theme in the debates over tax policy during the eighties was over the need to raise tax revenues after the very large reductions put in place by ERTA. If these reductions had not been so large, the debate over tax policy probably would not have been so sharp. Stewart emphasizes the decreased control by Congressional leaders in setting tax policy as an explanation for the size of the 1981 tax cut. When Republican and Democratic leaders in Congress reasserted their control in later years, tax favors to special interests were reduced.

Stewart also notes that in previous decades inflation pushed taxpayers with constant real incomes into higher tax brackets and thus automatically raised real tax revenues. Congress could then decide to spend these revenues or to take credit with constituents by voting to decrease taxes. When ERTA eliminated this bracket creep by indexing the personal income tax, revenues no longer increased automatically. Any change in taxation that raised total revenue or cut the taxes of one group required an explicit action to raise taxes on another group. Thus, indexing the personal income tax, along with Reagan's opposition to tax increases, also intensified the debate over tax policy.

David F. Bradford's comment on Stewart's paper discusses the paradox of a Republican administration introducing tax changes in ERTA that were extremely generous toward business investment and then supporting their elim-