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Macroeconomic Policies and Performance in the United States During President Reagan's First Four Years'

In ihrer ersten Amtsperiode gelang es der Regierung Präsident Reagans durch entschlossenes Engagement, die Inflationsrate in den USA um 5 Prozentpunkte zu senken. Dieser Erfolg konnte nur dadurch erzielt werden, daß man die Wachstumsrate der Geldmenge drosselte und entsprechend hohe Arbeitslosenquoten in Kauf nahm. Denn um die Inflationsrate um 5 Prozentpunkte zu senken, mußte die Arbeitslosenrate um zusätzlich 10 Prozentpunkte ansteigen, was einen Ausfall von über 25 % des jährlichen Bruttosozialprodukts bedeutete. Bezogen auf das nominale Bruttosozialprodukt von 1984 wurden so 900 Milliarden Dollar an Waren und Diensten weniger umgesetzt, d. h. 180 Milliarden Dollar für jeden Prozentpunkt, um den die Inflation gesenkt wurde. Die Regierung Reagan erreichte so auf der faktischen Seite der amerikanischen Wirtschaft - in bezug auf Output, Kapazitätsauslastung und Arbeitslosigkeit - die von ihr versprochenen Ziele nicht. Im Gegenteil, bei Anwendung vernünftiger historischer Maßstäbe muß man ihre Wirtschaftspolitik als einen totalen Mißerfolg bezeichnen.

Implausibly Optimistic Projections

American Presidents are inclined to be optimistic when outlining their macroeconomic goals, but the Reagan Administration's projections, which were announced on February 18, 1981 less than a month after Ronald Reagan was inaugurated, represent something of a record. The main elements are summarized by the numbers. (See *Table 1.)* The Administration forecast a rise in real output of 25 percent between 1980 and 1986, with annual growth rates of 4 to 5 percent from 1982 to 1984 and beyond, as compared to growth rates that averaged about 3 percent per year during the 1970s. Unemployment was projected to fall from the 7.4 percent rate inherited from the Carter Administration (the consequence of the 1979-80 OPEC oil price shock and the recession induced by Carter to fight the escalation of inflation) to about 6.4 percent during 1984, and then to 5.5 percent by 1986. Over the same period inflation would be halved, declining steadily from the near double digit rates prevailing when Reagan entered the White House to 6 percent per year by 1984, and to 5 percent per year by 1985-1986.

Most economists (including most of the President's orthodox conservative economic advisors) viewed these forecasts with profound skepticism, if not outright disbelief. Taken separately, the growth and unemployment projections, on the one hand, and the inflation projections, on the other, were credible. Holding aside the inflation rate forecasts, then, the projected growth of output was plausible and fully consistent with the anticipated decrease of unemployment. During calendar year 1980 actual real output was more than 3 percent short of potential output, and the actual unemployment rate stood more than a full percentage point above the so-called »natural« rate. Hence, there was no reason that an expansionary macroeconomic policy could not achieve real GNP growth rates of 4 to 5 percent for several years, which by Okun's law (see chapter 3) was bound to yield big declines in unemployment. What was wildly implausible was the Administration's claim that inflation would be dramatically reduced *at the same time* that output and employment were rapidly expanding.

Under the macroeconomic policy scenario announced by the Administration in 1981, disinflation would be achieved through a gradual reduction of money supply growth rates of about one percentage point per year. Hence, the annual rate of growth of the money supply would be lowered from the 7 percent rate prevailing when Reagan was inaugurated to something like 4 percent per year by 1984. Since inflation (and the nominal GNP growth) were running at near double digit rates during 1980-81 in the United States, the Administration's monetary targets implied that the growth rate of the real (price deflated) money supply would be negative, at least for a year or two. Prior experience indicated strongly that this was likely to throw the economy into contraction, putting heavy downward pressure on wages and prices. In other words, under the monetary policy proposed by the Administration there would be insufficient liquidity in the economy to finance the ongoing pace of nominal transactions and, until prices adapted fully to the new monetary regime, the growth of quantities as well as prices would be slowed. For in the American economy (as elsewhere) wage and price adaptation to disinflationary monetary policies occurs after a lag and, therefore, large sacrifices of output and employment are required to reduce inflation significantly.

Supply-Side Theory to the Rescue

How, then, did the Administration hope to achieve simultaneously its output, unemployment and inflation forecasts? Here the theory, or perhaps more accurately, the ideology, of the new »supply-side economics« proved useful. In their contemporary, controversial form, supply-side ideas are most prominently associated with Arthur Laffer, a University of Southern

California economist of no particular distinction among academic professionals, who built upon some less outlandish ideas of Robert Mundell, a very distinguished economist now at Columbia University. They were popularized by Jude Wanniski, once an editorial writer for the *Wall Street Journal* and now a private consultant, and Irving Kristol, a New York city neo-Conservative intellectual and essayist. More than anyone else, Jack Kemp, an ambitious, personable Congressman from Buffalo, was responsible for bringing supply-side ideas into the political process, and as a result of his dynamic salesmanship of supply-side policies Kemp became a real force in the Republican party.

The supply-siders argued that tax rates on income from labor and capital were high enough in the United States to have large, adverse effects on the supply of work effort, saving and investment. The disincentive effects at prevailing rates were believed to be great enough that tax reductions on the scale of the Reagan Administration (Kemp-Roth) proposals would sharply raise the incentive to work, save and invest and, therefore, would stimulate dramatic increases of productive effort, employment and real output. Labor productivity (output per worker) would be further enhanced as the increase of saving and investment induced by a supply-side tax cut deepened the stock of capital per worker.

Most supply-siders claimed that tax rate reductions would be self-financing. The supply-side-fueled expansion of output would enlarge the Federal tax base so much that government revenues would not fall, despite lower tax rates. Indeed, radical supply-siders went so far as to assert that revenues would actually rise as the incentives created by higher aftertax returns to work effort and investment took hold and unleashed a great surge of economic activity. Consequently, it was argued that neither Federal Government spending programs nor the Reagan Administration's forecast of a balanced Federal budget by fiscal year 1984 would be endangered by an aggressive supply-side tax reduction policy. Proposals for large cuts in individual and corporate tax rates became the centerpiece of President Reagan's fiscal program. However, under pressure from his more orthodox, conservative economic advisors, Reagan agreed that spending cuts would be necessary to keep the budget in balance, although he often talked of painless reductions confined to areas of »waste, fraud and abuse.«

Fiscal Policy Successes

President Reagan spelled out his tax and spending legislative package in a televised speech to a joint session of Congress on February 18,1981. The President called for a 27 percent across-the-board reduction ofpersonal income tax rates to be phased in over three years starting July 1. In response to con-

gressional resistance, Reagan offered a revised plan in June 1981 that trimmed back the first rate cut to 5 percent, and delayed it to October 1. The revised plan won approval by Congress, and was incorporated into the Economic Recovery Tax Act of 1981 (ERTA), which the President signed into law on August 13, 1981. ERTA reduced personal tax rates by 23 percent, with the initial, October 1, 1981 rate cut of 5 percent followed by 10 percent reductions on July 1, 1982 and July 1, 1983. Since the rate cuts were applied uniformly (»across-the-board«) to a progressive income tax system, the absolute and relative benefits rose with incomes and heavily favored high-income taxpayers.

Additionally, ERTA immediately slashed the top rate on unearned, investment income from 70 to 50 percent, and reduced the maximum rate on capital gains (taxed at 40 percent of the investment income rate) from 28 to 20 percent. Hence, the top tax rates on income from capital were cut by a factor of 29 percent. The bill passed by Congress also included a number of savings incentives, most notably extensions of Self-Employed Retirement Plans and Individual Retirement Accounts, and the creation of »All Savers« interest income exclusions.

More important, ERTA provided for indexing of the rate brackets to inflation (the increase in the CPI during the previous year) beginning in 1985. As a political matter, this helped lock into place a new rate structure that disproportionately benefited the rich. The indexing provision of ERTA would make it more difficult later on for the Democrats, when and if they regained their traditionally dominant position in the Congress, to attempt to undo ERTAs redistribution of tax burdens by using inflation as the occasion to reopen the issue of the income tax.

The tax bill proposed by the Administration and passed by Congress called for a sharp reduction in effective corporate tax rates, primarily through replacement of the existing system of depreciating assets over their »useful« lives with a simplified Accelerated Cost Recovery System (ACRS) that permitted businesses to write off the value of an asset over 3, 5,10 or 15 years at an accelerated rate. ACRS was so generous that the dollar value to firms of tax deductions and credits typically exceeded the tax liabilities on the extra income produced by investment in new equipment. In other words, the effective marginal tax rate on investment in new equipment was negative. Moreover, under ERTA businesses were permitted to use their surplus tax benefits to offset tax liabilities on income from other sources and to »lease« them to other firms through sale-leaseback arrangements. Shortly after ERTA was passed, the full implications of ACRS became clear, and they were widely viewed as overly generous. Along with growing concern about the size of impending Federal deficits, this prompted Congress to pass, and the President to sign into law, the Tax Equity and Fiscal Re-

sponsibility Act of 1982 (TEFRA), which repealed about half the business tax reductions conferred by the 1981 ERTA legislation. However, the rest of the Reagan Administration's 1981 tax package remained in place into the President's second term.

President Reagan also had considerable success with the spending side of his fiscal program. The biggest victories were achieved in the first year. Thanks to feverish work at OMB, directed by the brilliant David Stockman, the Administration's fy 1982 budget request, along with proposed adjustments to Carter's fy 1981 spending totals, were submitted to Congress in March 1981, less than a month after Mr. Reagan entered the White House. The Reagan budget called for a fy 1982 budget defense expenditure increase of 7.2 billion dollars above what Carter had requested, and a reduction in non-defense expenditures of 41.4 billion dollars from the Carter policy base line. Through ingenious use of congressional budget »reconciliation« procedures, Stockman coordinated the bundling of the Administration's spending proposals into one unified package, which was pushed through the Congress with breathtaking speed. The Omnibus Budget Reconciliation Act passed Congress in July 1981. It was the deepest and most widespread package of budget cuts ever passed by Congress. The President received all of the defense spending increase he wanted, and the lion's share of the requested social spending cuts: nondefense programs were cut by about 35 billion dollars.

However, President Reagan was unable to repeat the great budget successes of 1981 in subsequent years, as many Republicans in Congress, including the Republican leadership, joined Democrats in opposing further major cuts in social spending. Yet over the first term as a whole, the Office of Management and Budget estimated that the Administration achieved at least one-half of the nondefense spending cuts initially called for in the 1981 budget statement. The Congressional Budget Office estimated that by fy 1985 nondefense program spending stood about 60 billion dollars, or 1.5 percent of GNP, lower than the pre-Reagan policy base line, as compared to fy 1985 reductions on the order of 2 to 3 percent of GNP envisioned in the President's February 1981 announcement. Moreover, the President was successful in obtaining most of the defense spending buildup he requested. The February 1981 budget projections called for defense outlays to rise by about 1.2 percent of GNP from fy 1981 to fy 1985.[2] By the 1985 fiscal year increases in military spending equivalent to approximately 1 percent of GNP had been achieved. These budgetary shifts were somewhat less than the President wanted, but they amounted to far more than seasoned analysts thought possible when Mr. Reagan entered the White House.

Monetary Policy Responsiveness

Monetary policy conformed almost perfectly to President Reagan's preferences during his first term. The Administration's initial monetary goals, outlined by Beryl Sprinkel, Under Secretary of the Treasury for Monetary Affairs, called for the growth rate of the M1B money supply to decelerate by about a point each year from 7 percent per year in 1981 to 3 percent per year in 1985-86. The Federal Reserve, chaired by Paul Volcker, a highly regarded central banker wellknown for his anti-inflationary zeal, delivered money supply growth rates for 1981 and 1982 that corresponded closely to the Administration's initial targets. M1B grew by 7.1 percent in 1981 and 6.5 percent in 1982, a highly contractional policy given the prevailing growth rates of prices and nominal GNP.

Predictably, the monetary austerity of 1981-82 created a deep, disinflationary recession. But the President »stayed the course« until late 1982, at which time double digit unemployment rates (and, no doubt, the fact that the presidential election season loomed on the horizon) led him to abandon hard-line monetarism and push for an expansionary monetary policy. Paul Volcker and the Federal Reserve proved to be as cooperative on the »up side« as on the »down side.« The M1B money supply grew at annual rates of about 11 percent in 1983 and 7 percent in 1984. Since inflation had declined sharply to 3 to 4 percent per annum in 1983 and 1984 as a result of the deep 1981-82 contraction, the real (inflation-adjusted) money supply growth rate soared. Real M1B grew by more than 7 percent in 1983, which provided a big monetary stimulus to the economy and, in conjunction with enormous Federal budget deficits, fueled the big 1983-84 election year recovery of output, incomes and employment.

Viewed as a whole, then, President Reagan was remarkably successful in obtaining the mix of fiscal and monetary policies he wanted from the Congress and the Federal Reserve. At first, both the monetarists and the supply-siders were satisfied. Monetarists got the long stretch of tight money (from late 1979 to late 1982) they had been advocating to bring inflation down. The supply-siders (and high-income taxpayers) got nearly all the tax relief they had argued was necessary to revive incentives to »work, save and invest.« Yet it was the Administration that forged the politically convenient marriage of supply-side)fiscalism< and hard-line monetarism, which superficially reconciled an implausible combination of growth, unemployment and inflation (and balanced budget) forecasts. The idea that supply-side fiscal policy would offset, indeed more than offset, the contractional effects of an austere, disinflationary monetary policy by stimulating an unprecedented surge of extra work effort, investment and output, came from the Reagan Administration, not supply-side advocates (or monetarists). Supply-side theorists were preoccupied with the problem of incentives and growth

rather than inflation, though many advocated a return to the gold standard as the way to stabilize the money supply and the price level. Indeed, it was not long before the supply-siders began to complain bitterly about the Administration's support for hard-line monetarism. The numbers in *Table 1* show why.

Table 1:
Macroeconomic Goals, Outcomes and Policies During Reagan's First Term (goals/projections are from February-March, 1981)

	Annual Averages By Periods and Years						
	1970-79	1980	1981	1982	1983	1984	1981-84
Output, Unemployment and Capacity Utilization							
Real GNP Growth Rate							
Actual:	3.2	-0.3	2.5	-2.1	3.7	6.8	2.7
Projected:		–	1.1	4.2	5.0	4.5	3.7
GNP Gap (percentage deviation of actual from natural GNP)							
Actual:	-0.8	-3.3	-3.8	-8.9	-8.3	-4.5	-6.4
Growth Rate of Per Capita Real Personal Disposable Income							
Actual:	2.4	-0.6	1.7	-1.3	2.5	5.8	2.2
Percent Idle Capacity in Manufacturing							
Actual:	18.3	20.4	20.6	28.9	24.8	18.3	23.2
Unemployment Rate							
Actual:	6.3	7.1	7.6	9.7	9.6	7.5	8.6
Projected:	–	–	7.8	7.2	6.6	6.4	7.0
Personal Saving and Private Investment							
Personal Saving as a Percentage of Personal Disposable Income							
Actual:	7.3	6.0	6.7	6.2	5.0	6.1	6.0

	1970-79	1980	1981	1982	1983	1984	1981-84
Gross Real Private Domestic Investment as a Percentage of Real GNP							
Actual:	17.0	14.1	15.3	13.1	14.4	17.7	15.1
Net Real Private Nonresidential Fixed Investment as a Percentage of Real GNP							
Actual:	3.0	3.0	3.2	2.3	2.2	3.8	2.9
Inflation							
Annual Rate of Change of GNP Deflator							
Actual:	6.6	8.8	9.2	5.8	3.8	3.7	5.6
Projected:	–	–	9.9	8.3	7.0	6.0	7.8
Montetary and Fiscal Policy							
Money Supply Growth Rate (M1B)							
Nominal Actual:	7.7	6.2	7.1	6.5	11.1	6.8	7.9
Projected:	–	–	7.0	6.0	5.0	4.0	5.5
Budget Deficit (-) or Surplus (Fiscal Years)							
Billions of dollars							
Actual:	-40	-74	-79	-128	-208	-185	-150
Projected:	–	–	-55	-45	-23	+0.5	-31
As Ws of GNP							
Actual:	-1.7	-2.8	-2.7	-4.2	-6.3	-5.1	-4.6
Projected:	–	–	-1.9	-1.4	-0.6	0	-1.0

Sources: The White House, »America's New Beginning: A Program for Economic Recovery,« February 18, 1981 (Unemployment, inflation and real GNP growth rate projections); Beryl Sprinkel's July 23, 1983 *Statement before the House Committee on Banking, Finance and Urban Affairs* (M1B growth rate projections, announced publically in February 1981). Actual data are from *Economic Report of the President,* various years, and the Citibank Economic Data Base.

The Economy's »Real« Performance Under >Reaganomics<

Less than a year into the new Administration's term it was becoming obvious that President Reagan would have to choose between his inflation and output-unemployment goals. The policy mix that Senate majority leader Howard Baker, Republican of Tennessee, had colorfully described as »a river boat gamble,« was not working as planned. Neither preannouncement of a monetary slowdown nor the credible application of monetary stringency nor the marriage of monetary austerity to supply-side tax cuts was succeeding in lowering inflation without imposing enormous costs in lost output, lower incomes and higher unemployment. The Phillips-curve tradeoff between prices and quantities, that is, between nominal and real economic performance, remained alive and well in the U.S. economy.

Fiscal policy was expansionary throughout Reagan's first term because the loss of revenues from the tax cuts and the rise in military spending outran the reductions in social outlays, generating large deficits. But extremely tight monetary policy overwhelmed the fiscal thrust, and the surge of economic activity (and tax revenues) promised by the supplysiders failed to materialize. President Reagan gave clear priority to the goal of achieving significant disinflation. For nearly two years the White House backed a tough monetary policy. Consequently, output growth collapsed, idle capacity rose sharply, and unemployment soared. The American economy's real performance during Reagan's first four years was far less favorable than during the much maligned 1970s; indeed it was without precedent since the late 1930s. The data at the top of *Table 1* tell the story.

When Mr. Reagan entered the White House the U.S. economy had been in recovery from the 1979-80 OPEC shock and Carter's policy-induced recession since July 1980. But monetary policy in 1981 and 1982 completely aborted the recovery, and the growth rate of real GNP was an anemic 2.5 percent in 1981 before tumbling by more than 2 percentage points in 1982. Once monetary policy was relaxed as the Administration urged in late 1982, growth rates responded briskly. The 1984 election year growth of real output and incomes was especially impressive.[3] Yet over Reagan's entire first term, real GNP growth rates averaged only 2.7 percent, which is a half point lower than the growth rate record of the 1970s, and a full point lower than the average implied by the Administration's forecasts. Even real disposable income growth rates were lower on average over 1981-84 than during the 1970s, despite ERTA's transfer of hundreds of billions of dollars to personal incomes, financed by ballooning Federal deficits.

The trajectory of »real« economic performance in the United States over 1981-84 is more accurately mapped by looking at movements in the gap

between actual and potential real output, shown in the next row of *Table 1*. The percentage shortfall of real GNP from its sustainable level rose from 3.3 percent in 1980 to well over 8 percent in 1982 and 1983, before declining to 4.5 percent in 1984.[4] The 1982 and 1983 GNP gaps were by far the highest of the postwar period, and the average over the Reagan's entire first term, -6.4 percent, was the worst of all postwar American Administrations. Net of the 3.3 percent shortfall inherited from Carter, a gap amounting to more than 22 percent of a year's GNP was accumulated during Reagan's first term. This translates into about 825 billion dollars worth of 1984:4 goods and services, or close to $10,000 per household.

Manufacturing industries were hit particularly hard during the Reagan years. The Federal Reserve Board's capacity utilization data reported in *Table 1* indicate that idle capacity reached almost 30 percent in the manufacturing sector over 1982, the most depressed level in the postwar period. And, averaged over the President's entire first term, idle capacity was 5 percentage points higher than the mean for the 1970s. Except for numerous bankruptcies and plant closings, which also reached record levels during the Reagan Administration, the data would paint an even worse picture. Despite the 1983-84 recovery, during the last year of Reagan's first term capacity utilization was still no better than the 1970-79 average.

In many ways the saddest aspect of the Reagan record, because of the human tragedies involved, is revealed by the unemployment statistics. Instead of falling steadily from the 7.4 percent rate inherited from Carter, as the Administration claimed it would if Congress passed the Reagan tax and spending package, unemployment in the United States rose continuously from mid-1981 until the recovery began at the end of 1982. Joblessness peaked at 10.8 percent of the civilian labor force in December 1982, the highest level since the Great Depression. The unemployment rate for all of 1982 and 1983 averaged close to 10 percent. During these years America experienced a shameful phenomenon not seen since the 1930s: tens of thousands of unemployment's victims crisscrossing the country looking for work, ineligible for unemployment benefits, forced to rely on soup lines, and unable to apply for welfare because of the lack of a home address. And, notwithstanding the steep decline of joblessness during the 1983-84, much heralded by the Administration, unemployment stood no lower at the end of President Reagan's term than at the end of President Carter's.

The Response of Saving and Investment to the Reagan Program

It is clear in retrospect the medium-run consequences of Reaganomics adversely affected the performance of the real macroeconomy. Yet the President's program might have enhanced the economy's longer-run prospects if the ERTA tax cuts had changed fundamentally American saving and investment behavior. However, the empirical data in *Table I* indicate this failed to occur.

Personal savings rates in the United States over the postwar years prior to the implementation of President Reagan's tax package were remarkably stable in the face of variations in inflation, interest rates and effective tax rates. The Economic Recovery Tax Act of 1981, which put hundreds of billions of dollars into the hands of the taxpayers (especially high-income taxpayers), produced no increase at all in aggregate personal savings rates. In fact, the data in *Table/*show that average personal saving out of personal disposable income was actually lower during 1981-84 (6 percent) than during the 1970s (7.3 percent) or, for that matter, than during the entire postwar period up to Reagan (6.9 percent).

Although raising personal saving rates was seen as a desirable objective by advocates of the President's tax package, what really counts for the long-run performance of the private economy is the rate of *investment,* personal and corporate, in the private sector. But here too, Reagan's fiscal policy produced no improvement. Predictably, private investment in the United States declined with the deep 1981-82 contraction and bounced back with the 1983-84 recovery. However, averaged over the business cycle, the statistics on new investment reveal no deepening of the capital intensity of production during President Reagan's first term.

The data on gross real investment in the entire private economy as a fraction of real GNP indicate that the average for 1981-84 (15.1 percent) was nearly two points lower than the corresponding mean for the 1970s (17 percent). More important than economy-wide private sector investment (which includes investment flows to owner-occupied housing), is investment in new plant and equipment, *net* of what is necessary to offset deterioration of the existing capital stock. But there was no improvement in this critical area either. Over 1981-84 net real private nonresidential investment as a fraction of real GNP averaged just 2.9 percent, as compared to 3 percent for the 1970s and Carter's last year. Other statistical series on investment tell a similar story: Despite a sizeable reduction in tax rates on new investment, the average rate of growth of America's capital stock was no better, indeed apparently it was slightly worse, under Reaganomics than before.

Disinflation During the Reagan Years

The principal macroeconomic success of President Reagan's first term was a substantial reduction in the U.S. rate of inflation. The annual rate of change of the GNP deflator (a better measure of the true inflation rate than changes in the Consumer Price Index) was lowered by about 5 points, from the 9 percent range of 1980-81 to under 4 percent in 1983-84. Indeed, the Administration achieved more rapid disinflation than it had projected in early 1981 (see *Table 1)* because it tolerated very high unemployment levels for so long.

The connection of high rates of unemployment (and large GNP gaps) to lowered inflation rates in the United States is well known. A standard »Phillips-curve« rule-of-thumb for the American economy is that the fundamental, annual inflation rate tends to fall a half percentage point for each extra annual percentage point of unemployment. (By »extra« unemployment, I mean deviations of the actual, official rate from the so-called »natural« or non-accelerating inflation rate. Following convention, I refer to this deviatibn as the »unemployment gap.«) Hence, a one point drop in fundamental inflation typically requires two extra percentage points of unemployment for a year, or one extra point sustained two years, and so on.

The standard Phillips curve, based on data for the U.S. economy from 1950-80, accounts for the disinflation achieved over 1981-84 with remarkable accuracy. Cumulative excess unemployment over 1981 to 1984 - assuming, as most moderate Keynesians do, that the natural unemployment rate in the United States was about 6 percent in those years - amounted to 10.4 percentage points. According to the Phillips-curve rule-of-thumb, this should have produced a decline in the annual inflation rate of about 5.2 percentage points between 1980 and 1984. As the data in *Tablet* show, this is exactly what happened. In fact, since the disinflation calculations take no

Table 2:
Cumulative Disinflation, Excess Unemployment and GNP Gaps, 1981–1984

	Change in Inflation (from 1980, GNP deflator)	Cumulative Excess Unemployment (U-UN)	Cumulative GNP Gap (percentage deviation of actual from potential)
1981	–	1.6	- 3.8
1982	-3.0	5.3	-12.7
1983	-5.0	8.9	-21.0
1984	-5.2	10.4	-25.5

account of the decline in food and energy prices during 1981-82, only some of which can be attributed to contractional monetary policy, it is perhaps surprising that America's inflation rate did not decline by a bit more than it did.

A Brief Summary of the Reagan Economic Record

As a result of a determined commitment to a slowdown in money supply growth rates and a corresponding willingness to tolerate historically high levels of unemployment, the first Reagan Administration presided over a substantial reduction of inflation in the American economy. But the cost was very high. »Credibility« arguments and new classical, rational exp ectafions theories holding that a sustained monetary slowdown would lower inflation without imposing large losses of output and employment, proved to be of no relevance empirically.

Just as most Keynesians would have predicted, the 5 point reduction of the annual inflation rate took at least 10 extra annual percentage points of unemployment. Consistent with the so-called Okun's law relation between aggregate real output shortfalls and unemployment gaps, the cost of the 5 points of disinflation amounted to more than 25 percent of a year's GNP. *(Table 2,* last column) In 1984 prices that translates to about 900 billion dollars of foregone goods and services, or 180 billion dollars per point of lowered inflation. It is hard to escape the conclusion that insofar as the real side of the American economy is concerned - output, incomes, capacity utilization and unemployment - President Reagan's program not only fell short of what was promised, but was an outright failure.

Footnotes

1 This essay is excerpted from chapter 10 of my forthcoming book *The American Political Economy: Macroeconomics and Electoral Politics in the United States,* which I completed during my Fellowship period at the Wissenschaftskolleg. I decided to submit my evaluation of American macroeconomic performance under Reagan to the *Jahrbuch* because many Europeans seem to believe that the Reagan Administration's economic policies were »successful.« The facts, however, show that this view is mistaken.

2 The magnitudes of the raw defense spending numbers requested by the President prompted many alarming accounts of the scale ofthe projected defense budgets. In fact, Reagan's plan merely called for restoring defense spending as a fraction of GNP to the levels prevailing in the early 1970s, and the proposed rate of increase relative to GNP was much less than the 1950-53 Korean War build-up and only slightly greater than the 1965-68 Vietnam build-up. The shift from civilian to military spending proposed by the President may have been unwise, but surely it did not »wreck« the economy as, for example, Lester Thurow (»How to Wreck the Economy,« *New York Review of Books,* May 14, 1981, 3-8) and others suggested it would. The disinflationary monetary policy backed by the White House during 1981-82, not the growth of defense spending, is what crippled the economy. See the discussion in the next section.

3 However, the performance of 1984 did not carry over to 1985. In the first quarter of 1985 the annual real GNP growth rate slumped to 0.3 percent. Real growth was about 1.7 percent for the second quarter, yielding subpar performance for the first half of 1985 as a whole.

4 In 1985 the GNP gap again increased with the slump in growth rates from the election year high.