



# President Reagan's Economic Legacy: The Great Expansion



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# **The Reagan Legacy: A Personal View**

**by Senator Connie Mack**

When I first ran for Congress in 1982, I believed that our country was at a pivotal moment in its history. Just two years earlier, in our most important election in post-World War II era, Americans opted for a clean break from decades of increasing government interference in the economy and chose Ronald Reagan as President. Reagan's policy prescription for our ailing economy was simple yet profound, and can be summed up in one word: Freedom.

Campaigning for President, Reagan pledged a return to basics, a restoration of the principles that made the United States special in the world. Alone among nations, we were founded on the premise that government should serve the people, and must be restricted in its powers so that individual freedom can be maximized. The first Americans transcended the view that rights were granted at the sufferance of rulers, and established a republic whose government did not create rights but instead protected the God-given rights of men and women.

For decades, these principles held firm and the United States stood as a beacon of hope and opportunity to people from all points on the globe. Unlike the nations of Europe, ours was a society without a rigid class structure, a society that promised equal opportunity for all, based on individual enterprise and hard work, not government privileges and connections. The European approach required large bureaucracies that intruded upon every sphere of commercial life. The American approach required no bureaucracy, just the desire of an individual to shoulder the risk and responsibility that is part and parcel of private enterprise. Judging from the immigration patterns of the last two centuries, it is clear that the market for freedom is bullish.

But this distinctly American way was challenged by two worldwide crises in the 20<sup>th</sup> century. First came the Great Depression. Although gross government mismanagement of the money supply and counterproductive trade policies caused the crisis, government was put forward as the cure. This led to the proliferation of alphabet agencies seeking to steer every aspect of the American economy, as government assumed a new role of redistributing income.

The second crisis was the rise of totalitarianism in Europe. The United States won World War II, but in the process of defeating one brand of tyranny, an equally malevolent totalitarian force came to occupy half of Europe. And the war effort was used to justify price controls and economic intervention that were unprecedented in the United States.

The welfare state in America grew by leaps and bounds, as once it was conceded that the government is the guarantor of income, each successive call for bigger programs became harder to resist. At the same time, the consolidation of the Soviet bloc presented a large threat to freedom, and presented new and costly challenges for America. Exaggerated reports of Soviet economic success fueled the call for greater government involvement in the U.S.

economy. Over time, confiscatory tax rates and regulatory excesses accumulated like barnacles to slow the mighty ship of American private enterprise.

Ronald Reagan saw clearly that the problem was too much government, and the solution was more individual freedom. When he became President, we were suffering from high inflation and high unemployment. To combat the first, he prescribed reducing the growth of the money supply, desiring that the Federal Reserve end the economic damage caused by high and volatile inflation. The second problem required deep cuts in the confiscatory tax rates that were deterring work, saving, and investment. However, the Federal Reserve slowed inflation sooner than Congress could deliver tax cuts, which were phased in over three years. The Fed had overreacted to the stimulus of tax cuts that had not yet arrived, exacerbating the economic downturn, throwing the budget seriously out of balance, and jeopardizing Reagan's tax rate reductions.

In the recession of the early 1980s, the economic policies of President Reagan that inspired me to public service came under attack. In the now famous "Stay the Course" campaign of 1982, the President's party retained control of the Senate, minimized losses in the House despite the dire economic times, and preserved the Reagan economic program. We also kept on track President Reagan's defense policies, which were under attack from short-sighted critics who were unwilling to pay the price to ensure our freedom, and who had no interest in assisting those struggling to gain their own freedom from Communist tyranny. The President's opponents naively thought that offending the Soviet Union was dangerously bad manners. I am proud to have first stood for election that fateful year, when President Reagan's detractors stood a chance of putting his programs in jeopardy.

Eighteen years later, the world is a far different and far better place thanks to President Reagan. We are still reaping the benefits of an economic environment shaped by his policies of low tax rates, monetary stability, open trade, and reliance on markets. One wonders whether our entrepreneurs and innovators would have had the chance to transform our economy into the new knowledge economy if risk-taking continued to be undermined by high tax rates, high interest rates, and high inflation.

President Reagan changed the economic environment in one additional way, harder to measure yet impossible to ignore. President Reagan, in his optimism about the future, in his confidence that free people in a free economy would prevail over any obstacle, was the embodiment of the American ideal. His spirit was the spirit of our land, the spirit that settled our vast continent, that placed a man on the moon, and that continually invents new frontiers to tame. During those dark days of 1982, he never lost faith, knowing in his heart and mind that freedom worked.

And how it has! We are enjoying the prosperity of the Great Expansion, eighteen consecutive years of nearly unbroken economic growth with low inflation. The Soviet Union is now just a grim footnote in history, and the millions of former captives behind the Iron Curtain are now our friends and trading partners. The people of Eastern and Central Europe who are now free; our neighbors in Latin America who enjoy stable democracies; the people of Western Europe and Asia whose governments followed our lead in economic policies; no

less than the people of our country, they owe President Reagan a debt of gratitude for leading the way out of the dead end of collectivism.

## **The Mess Reagan Inherited**

Younger Americans have a hard time imagining how bleak our nation's prospects appeared before Reagan assumed the Presidency, and even many who lived through those years may have forgotten the sense of pessimism that took hold in the 1970s. Our economy had recurrent bouts of high unemployment and high inflation that confounded most economists. Consumers and businesses suffered from a continuing energy crisis. Real household incomes were shrinking as "bracket creep" raised everyone's income tax bill year after year. The response of the incumbent administration was not inspiring, and ranged from "voluntary" wage and price controls to the exhortation that we must learn to live within limits. In short, the Establishment was telling Americans to accept that they no longer controlled their own economic destinies.

The loss of confidence by American leaders also surfaced in foreign affairs. The prevailing view of the intellectual elite was to shun any provocative talk regarding the Soviet Union, let alone action. The establishment conceded Soviet military supremacy—indeed, a Secretary of State counseled accepting the reality that the U.S. was the number two power. The post-Vietnam lack of nerve was compounded by the seeming economic helplessness.

U.S. weakness in foreign affairs was exploited by the enemies of freedom. Abroad, Iranian students inspired by their country's Islamic revolution were holding 50 Americans hostage. A new communist government was consolidating its stranglehold over Nicaragua and preparing to incite revolution throughout Central America. The Soviet Union had invaded Afghanistan. America's leadership had let slip from its hands the proud banner of liberty, and the rest of the world took notice.

Ronald Reagan, emerging from the political wilderness, dared raise the standard of freedom and rallied the nation behind it. To those who counseled peace at any price, he answered with peace through strength. The advocates of a status quo of captive nations were met with the Reagan Doctrine of aid to anti-communist freedom fighters. And to those who said we need to "live within limits," he replied that, "There are no such things as limits to growth...because there are no limits on the human capacity for intelligence, imagination, and wonder." Here was a man who had not given up on America.

Candidate Reagan's call to arms was particularly bracing for me. I saw the obvious connection between the expansion of government and our worsening economic performance. When I started in the banking business in 1966, I probably spent 90 percent of my time engaged in activities that I considered productive: designing new services to attract business, working to increase the market share and profitability of the bank. The rest involved government paperwork. By the time I left banking in 1982, the ratio had completely reversed: I was spending 90 percent of my time trying to make sure my bank complied with government regulations and mandates. There was a constant stream of letters from the

government dictating how to manage our business. We got letters from the Comptroller of the Currency, the Treasury, the Federal Deposit Insurance Corporation, and the Federal Reserve, on topics ranging from flood insurance to so-called truth-in-lending. I even received a letter from Fed Chairman Volcker detailing which types of loans we could and could not make. Loans for adding bedrooms to houses got the government seal of approval, but loans for adding swimming pools didn't. Such government micromanagement made no sense.

From my experience in the banking business, it wasn't hard to understand why we as a nation were having difficulty competing: we had moved so many resources away from productive activities and into complying with government regulations. Over the years I had come to realize that the Keynesian economic theories I had been taught in college ignored how the choices and incentives of individuals are altered by government interference in the economy. By failing to account for the real world, those theories in practice had come pretty close to ruining that world. But along came Ronald Reagan, with a common-sense approach that went back to basics: free markets, free enterprise, free trade. Here was a man who had recognized that the government was a detriment to economic growth, a man who approached things from the perspective of freedom as opposed to government. I shared that perspective and recognized the importance of President Reagan's election. On election night, November 4, 1980, I knew that I had to get involved in his great campaign to restore freedom. I would have never guessed I would end up in Congress.

## **Reagan versus the Statists**

Reagan's bullish attitude about the potential of freedom ran counter to the prevailing view that was, perhaps, optimistic about a different goal. Starting in the 1970s, the media aggressively advanced the notion popular in intellectual circles that the free enterprise system was failing. After all, U.S. productivity growth had slowed since 1973. For most policymakers, the twin problems of inflation and unemployment seemed insurmountable, at least for a market-based economic system.

When I attended Harvard's congressional orientation program for House freshmen in December 1982, I remember hearing future Secretary of Labor Robert Reich preach the wonders of industrial planning. As late as 1989, prominent economists were still touting the Soviet Union's central planning. Consider Lester Thurow's remarks that year: "Can economic command significantly...accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can....Today it is a country whose economic achievements bear comparison with those of the United States." And our economics students were being taught from a textbook by Nobel laureate Paul Samuelson that proclaimed Soviet planning to be "a powerful engine for economic growth."

These mistaken views were not mere folly, but endangered our very society. The contest waged between East and West through most of the twentieth century was not a mere feud between two competing powers; it was a fight between the opposing philosophies of freedom and force, between free choice and coercion, between risk-taking and security. At the time Reagan took center stage in world affairs, the West was on the verge of conceding defeat.

Many suggested that capitalism was dead, and only some third way—European democratic socialism or a Japanese-style industrial policy—could stave off the necessity of totalitarian state economic controls. But all of these rivals to capitalism share the same decision-making structure: it is for the government, not the individual, to decide. People are reduced to mere statistics, rather than recognized as individuals who wish to plan their own lives. Not least, these approaches open the door to government corruption. When Ronald Reagan addressed a luncheon for my first Senate campaign, he rightly characterized so-called government “partnerships” with the private sector as “government coercion, political favoritism, and old-fashioned boondoggles nicely wrapped up in a bright colored ribbon.”

## **Reaganomics**

Ronald Reagan’s “Program for Economic Recovery” was the antithesis of the statist approach advocated by planners and their fellow-travelers. President Reagan discarded the notion that policymakers could fine-tune the economy. Instead, Reagan sought to establish a stable environment conducive for private-sector growth. This meant reducing inflation, and cutting taxes, regulation, and the size and scope of government. It meant restoring incentives for working, saving, investing, and succeeding. It meant opening America further to the benefits—and challenges—of international trade.

Reagan recognized that our economic problems were due to government trying to do too much. Rather than acting simply as a referee, government was trying to direct the actions of the players. President Reagan rejected the “government knows best” approach to the economy, which, he quipped, “could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”

President Reagan’s economic program was no hodgepodge of unrelated policies, but a logical approach to the problem of government distortion of the incentives faced by individuals and businesses. Reagan had a clear idea of what he wanted to accomplish and was confident his policies would work together to restore the economy. He assembled a capable economic team, spearheaded by Treasury Secretary Donald Regan, that was committed to his policies. Reagan summarized his approach in a declaration of early 1981, in which he said, “Reducing the growth of [government] spending, cutting marginal tax rates, providing relief from overregulation, and following a noninflationary and predictable monetary policy are interwoven measures which will ensure that we have addressed each of the severe dislocations which threaten our economic future.”

## **Federal Spending**

President Reagan recognized that our nation’s economy is comprised of billions of individual decisions made by citizens in their work, consumption, savings and other choices. Whatever spending the government engages in subtracts resources otherwise available to private citizens and businesses. This is true no matter how the government spending is financed, be it through taxation or borrowing.



Thus, Reagan rejected the idea that government spending was some sort of magic cure for economic slumps. He rejected the idea that government spending acted as a “stimulus” to economy. Instead, he asked whether each spending program was actually needed by citizens. His success in changing the debate still echoes in the halls of Congress, as exhibited most recently in the 104<sup>th</sup> Congress’s rejection of President Clinton’s so-called “stimulus package.”

There is always enormous pressure on Congress to spend more money. This pressure comes to bear even on those of us who consciously strive to control spending. Members of Congress come to think that money not spent in their home district or state will just be spent by other members. In addition, spending decisions seem far removed from the actual pain caused by taxing the resources from some distant and anonymous taxpayer. As a result, it is little wonder that government spending has a tendency to continually increase.

President Reagan entered the White House with one paramount spending goal: to rebuild our national defense, since national security is the most fundamental responsibility of the federal government. He realized that to provide this desperately needed public good, while cutting tax rates to unleash the productive forces of the nation, required fiscal restraint in the nondefense portion of the federal budget. The Reagan Administration proposed unprecedented reductions in federal outlays over its first five years, and won some hard-fought concessions from the Congress to reduce the budget’s nominal rate of increase. But the spending figures were still high, based on projections of continued high inflation. When inflation abruptly collapsed from 12.5 percent in 1980 to 3.8 percent in 1982, it turned out that expenditures actually went up faster than inflation. What were supposed to be real spending *cuts* ended up being real spending *increases*.

The difficulties President Reagan had in taming the Congressional urge to spend made a balanced budget and tax limitation amendment to the Constitution one of my top priorities when I entered Congress. It also motivated me to be the main House sponsor, along with Dick Cheney, of the Balanced Budget and Emergency Deficit Control Act of 1985 (the Gramm-Rudman-Hollings Act), which did work for a few years to hold spending down. Today, as much as ever, I believe some supermajority restriction on the ability of Congress to increase spending is necessary. And unless taxes are cut to keep the revenues from flowing into Washington, the trillions of dollars of surpluses that are projected over the next few decades will not last. If the taxes are collected, Congress will spend them.

## **Tax Cuts**

President Reagan’s most dramatic policy change was without a doubt his supply-side tax cut. It seems almost inconceivable today that just two decades ago, marginal income tax rates were as high as 70 percent in the United States. It was little wonder that our country was in economic decline, when its most economically productive citizens could keep only a 30 percent share of their additional earnings (and even less after subtracting state and local taxes). These high tax rates not only discouraged additional work and investment at the margin, but also confiscated capital that could have been used for job creation by the private sector.

Reagan's critics just didn't get it. They looked at his tax cut proposal through a Keynesian lens, and determined wrongly that tax cuts would fuel inflation. To the demand-siders, spending levels were all that mattered. They ignored the incentives faced by individuals, whose decisions really make the economy go. Reagan was reversing policies by his predecessors that had discouraged saving and investing. High inflation had eroded the value of savings and high taxes were confiscating the rewards from investing, so people were worse off when they delayed purchases.

By cutting income tax rates 25 percent across the board, Reagan restored a large measure of freedom to the American taxpayer—not just the freedom to spend money that would have been taxed, but the freedom that results when economic decisions are no longer influenced by high tax rates. It was not just about the dollars that would have been collected had tax rates stayed high, but the choices that would never have been made because of high rates; decisions to expand plant capacities or start new businesses, for instance. Lower tax rates encouraged a new flowering of entrepreneurship, which helped the United States take the lead in high technology and other industries of the new, information-age economy.

The opponents of tax cuts were proven wrong. Inflation, being a monetary and not a fiscal phenomenon, collapsed. Despite the deficits, interest rates declined as inflation was wrung out of the economy. But the critics of President Reagan were fixated on the budget deficit and favored tax increases rather than spending restraint. First there was a push to eliminate Reagan's indexing of tax brackets for inflation, so that loose monetary policy could push people into high brackets and, in theory, flood the Treasury with greater tax receipts. When that failed, the Democrats in Congress set their sights on repealing the third year of the across-the-board tax cut.

That's where I came in. I ran for Congress in 1982 to preserve the Reagan economic program. I believed that, once it was fully implemented, the tax rate reductions would unleash the entrepreneurial efforts of individuals across America. The economy was just starting to revive when I arrived in Washington, but I soon discovered that this mattered little to the President's detractors. A growing economy and rising employment were less important to them than whether the government financed its expenditures through borrowing or taxation.

I don't know if it was simply government's greed to expand the budget, envy of private-sector success, or the desire to defeat the President, but Reagan's opponents strongly wished to repeal the scheduled tax rate cut. However, I was just as motivated. I spearheaded an effort to collect 146 signatures from House members on a letter to President Reagan pledging to uphold his veto of any legislation that tampered with the third year of the tax cut. I collected the 146 signatures (the minimum necessary to uphold a veto) and the threat to repeal the tax cut dissipated.

My letter to the President caught the attention of an obscure junior Representative from Georgia named Newt Gingrich. He recruited me to join a small group of conservative members who held brainstorming sessions on ways to influence the Republican Congressional agenda. The core group included Ed Bethune, Dan Coates, Duncan Hunter, Henry Hyde, Dan

Lungren, Bob Walker, and Vin Weber. These meetings were exciting, as members discussed issues on a far different plane than you would hear in floor debates: actual ideas were analyzed, and members would talk about books and essays they had read. Soon we decided to broaden our membership. I was assigned the job of organizing what we called the Baltimore Conference, which was open to all Republican members and to the press, and which led to the formation of the Conservative Opportunity Society (COS). The COS soon became the vehicle for change in the House, challenging the leadership in both parties, highlighting our conservative, tax-cutting agenda. You might say we were the spirit of Reaganism in Congress. The COS set in motion a process that ultimately resulted in the Republican victory in the 1994 Congressional elections.

## **Monetary Policy**

Throughout the 1970s, monetary policy, like fiscal policy, came to be viewed as a matter of executive-branch discretion. Politicians who wanted more economic growth would urge the Federal Reserve to “prime the pump,” to add more money to the economy. According to the demand-siders, the increased spending would propel the economy, lowering unemployment at the slight cost of higher inflation. Adherents to this view are nowadays few and far between, as even academics and bureaucrats now concede what was obvious to those of us who were in the private sector: when the money supply grows faster than the economy, the only certain effect is a rise in prices. Increased demand does not mean increased jobs, just higher prices for the same amount of labor.

Ronald Reagan did not want the Federal Reserve to manipulate the money supply in an attempt to target interest or unemployment rates. All he wanted was price stability, the elimination of high inflation from the economy. It was not for the Fed to decide what was happening in the economy; that was the role of people in the private sector. In his view, the best economic environment that the Fed can provide was one in which inflation expectations played a small or non-existent role in long-term planning. Reagan’s appointees to the Federal Reserve Board, people like Alan Greenspan, Preston Martin, Manuel Johnson, Martha Seger, and Wayne Angell, shared his desire for price stability and a depoliticized monetary policy.

Throughout the Reagan years, the loudest and strongest advocate of stable prices in the Congress was Jack Kemp. Jack would talk tirelessly about the need for “a dollar as good as gold,” and his intellectual and political support for this position no doubt influenced President Reagan’s selection of Greenspan as Fed Chairman. Greenspan continues to hold sway at the Fed as part of the Reagan legacy, and his record at containing inflation has set a high standard. As a member of the Senate Banking Committee I have attempted to institutionalize this approach to monetary policy, sponsoring a bill that would make price stability, not economic growth or “stabilization,” the goal of the Federal Reserve. Thanks to the sea change in monetary policy initiated by President Reagan, this legislation is now a safeguard rather than a necessity.

## **Free Trade**

Any country that values individual freedom should recognize that protectionist policies restrict freedom. High tariffs and import quotas constrain individual choice and raise prices, harming every consumer. “Protecting” domestic industries with import constraints does businesses or consumers no good over the long run. Efforts to prop up inefficient businesses hold back our best producers and reduce the standard of living.

Ronald Reagan recognized the fallacy of protectionism. In large part this was due to his belief in competition and free enterprise. But his attitude was also shaped by his confidence in America. He was neither afraid of foreign competition, nor embarrassed that imports might be preferred over American goods. America, as a nation of immigrants, represents the best that the world can offer. More than any consumer good or other trifle, the main export of America must be the ideal of political and economic freedom, an ideal that is undercut by trade restrictions.

By signing a free trade agreement with Canada, opening free trade negotiations with Mexico, and proposing the dismantling of agricultural trade barriers in the “Uruguay Round” of the General Agreement on Tariffs and Trade, Reagan went on the offensive for trade liberalization. At a time when Japan-bashing was commonplace—when members of Congress were literally bashing Japanese-made electronics into pieces on the steps of the Capitol—Reagan did not retreat from his basic free-trade principles. The remarkable success of U.S. industries from computers, semiconductors, software, biotechnology and many others over the past two decades has vindicated Reagan’s belief that American business prospers best in an open and competitive free enterprise environment.

## **The Reagan Legacy**

Today, principally as a result of the supply-side policies pursued by the Reagan administration, the U.S. economy is healthy. Both inflation and unemployment are low. Productivity is growing rapidly and incomes are rising.

Any doubts that President Reagan is responsible for today’s bounty should be dispelled by considering a few fundamental questions. Would American economic growth be as robust today if the federal government still took 70 cents of every additional dollar of income from our most productive citizens? If the typical family were hit with a 49 percent federal income tax rate on top of an effective payroll tax rate of 14.2 percent?

Would our economy be so strong if we still suffered from double-digit inflation and interest rates, due to the politicized use of monetary policy to manipulate consumer demand? If the trend of the last two decades had been toward managed trade, rather than freer trade? Would entrepreneurs and innovators abound if high inflation and high tax rates on capital gains destroyed the returns to their risk-taking?

And would our country be as secure as it is today if instead of trading partners, the people of Eastern and Central Europe were still prisoners of the Soviet bloc? If our fellow Americans south of our border were still the potential victims of imported totalitarianism instead of full participants in established democracies?

Our debt to Ronald Reagan reminds me of an exchange mission I once went on, with congressmen Tom Foley and Dick Cheney, among others. In 1985, a delegation from Congress went to France to reciprocate an earlier visit by a group of French legislators. After spending some time in Paris, each of us was assigned to a member of the National Assembly and we accompanied them to their districts. I went to a district near Le Mans. An extensive tour ended in a town hall meeting, where some of my host's constituents questioned me for some two hours. At the end of the meeting, I asked my host, François, if I could ask them a question. He assented, and I asked what they thought about America, so I could tell it to the people of Florida when I went home the next day.

The first person stood up and said, "we think of America as a dynamic, growing, thriving, exciting place." A second man got up and said basically the same thing. The third person to address me was a man who was probably in his late 70s or early 80s. He was stooped over, his weight being supported precariously on an old, gnarled cane. He came over closer to me, looked me directly in the eyes, and said, "You tell the people of America that we will never forget that it was the American G.I. who saved our little town. You tell them we'll never forget!"

Well, I feel that way about Ronald Reagan, my political hero, who inspired me in my very first run for office. America will never forget what President Reagan did for us. He gave us back faith and renewed our belief in this country. He gave America back its pride. He rebuilt America's defenses. His economic policies reduced taxes, reduced inflation, and reduced unemployment. He put America back to work again. He reminded America what made us a great nation. And he won the Cold War without firing one shot.

The citizens of America and the people of the world will never forget.

## **I. The Conditions for Strong Economic Growth**

The entry into office of the Reagan Administration in 1981 saw a dramatic rethinking of federal economic policy. The economic policy failures of the 1970s, combined with the incoming president's commitment to limited government, resulted in new approaches to inflation, taxation, regulation, and spending in the 1980s. The Reagan policies were not a quick fix. Instead, they were designed to create an environment that would promote strong long-term growth. They not only turned the economy around during the 1980s, but provided the foundation for the dynamic growth of the 1990s. This section discusses some of the underlying conditions for long-term growth, and the following sections discuss how well these conditions were met in the 1970s and 1980s.

Economic growth is the key to higher living standards. Over long periods, seemingly small differences in growth rates have big effects on income levels. For example, an average annual growth rate of 2 percent results in a doubling of incomes every 35 years. As a consequence, over the long run even differences in growth rates of a tenth of a percentage point per year can make big differences in living standards.

While economic growth is complex, Exhibit 1 lists its most important ingredients. Economists used to focus mainly on investment in physical and human capital as the source of strong growth. In recent decades, they have also focused on the importance of technological advances in promoting growth.

However, considering only the various factors of production (capital, labor, and technology) does not adequately explain why some countries have succeeded and others have fallen behind. It turns out that without a favorable policy environment, investments in labor and capital will not produce the desired economic growth. We now explain the elements of a policy environment favorable to growth.

### **Exhibit 1: Key Determinants of Economic Growth**

1. Investment in physical and human capital
  2. Technological advancements
  3. Basic economic environment
    - a. Property rights and political stability
    - b. Price stability
    - c. Open and competitive markets
    - d. Open international trade and investment
    - e. Limited government
-

## **A. Property Rights and Political Stability**

A legal system committed to protecting individuals and their property is a minimal prerequisite for sustained economic growth. Well-defined and well-enforced property rights protect owners from fraud, theft, and expropriation. Without property rights, entrepreneurs and investors will not be willing to buy land, equipment, and other expensive fixed assets that fuel economic growth.

Private ownership of property is superior to public ownership in creating incentives for productive activities and holding people accountable for their actions. People get ahead by providing things that others value, and by engaging in actions that increase the value of resources. Scarce resources are allocated to their best uses and wasteful, inefficient activities are minimized.

Like secure property rights, political stability encourages long-term growth because investors want to be confident that policies will not change so radically as to eliminate returns from investments. If the political regime is expected to change substantially, property may be expropriated or taxed away. Investors also want assurance they will not be subject to bureaucratic corruption, which creates uncertainty about the rules of economic activity. A recent cross-country study published by the National Bureau of Economic Research found that corrupt governments create great uncertainty for foreign investors, who respond by reducing their flows of direct investment.<sup>1</sup>

A recent example of uncertainty created by politics is the drop in biotechnology share prices in May 2000 in response to statements by President Clinton that implied a possible change in the U.S. government's policy on patenting new developments in genetic research. After the plunge, one investment advisor noted, "I think this is a brilliant illustration of what happens when government policy changes suddenly....A critical component of technology innovation and business innovation is policy stability, not just in patent rights, but also in taxes, property rights, monetary policy and international trade."<sup>2</sup>

## **B. Price Stability**

Sound money is necessary for efficient trade. After all, money and prices are the mechanism through which information about supply and demand of millions of products are transmitted in the modern economy. The price system is the nerve system of the economy. Relatively stable prices and interest rates encourage businesses and consumers to plan for the long term. High or volatile inflation discourages saving and long-term investment, wasting resources and stunting economic growth.

Persistent increases in the general level of prices are always the result of too much money chasing too few goods. Governments can achieve price stability by keeping growth in the supply of money under control. When the general level of prices shows signs of rising, the Federal Reserve can combat inflation by draining reserves from the financial system and increasing short-term interest rates. The Federal Reserve can combat deflation—a decline in

the general level of prices—by shifting to a more expansionary monetary policy. Price stability contributes to economic growth in numerous ways:

- Price stability reduces the uncertainty accompanying economic decisions that involve transactions across time, such as saving and investing.
- Price stability results in the price system providing more accurate information about efficient uses of products and resources. High inflation distorts this information since not all prices in the economy change to the same degree in inflationary periods.
- High and variable inflation wastes time and effort as individuals and businesses try to protect their wealth from future price increases. People divert resources from production into inflation hedges and speculative investments.
- Inflation distorts the tax code, which is not fully indexed to reflect changes in prices and incomes. Inflation can create a larger tax burden on savings than was intended, as in the case of income from capital gains. Inflation can also create distortions between different investments because of their varying tax implications.

## C. Competitive Markets

Competition is the disciplining force of a market economy. Market competition makes self-interested individuals engage in actions that promote the general welfare. Producers must woo the dollar “votes” of consumers away from other suppliers. To do so, they must produce good products at low cost, or else they will go out of business.

In the short term, competition results in lower prices and improved quality and service. In the long term, competition is essential for innovation and advances in technology. Industries that lack competition have few incentives to incorporate new scientific or engineering advances into products. Competition is a powerful stimulus for growth and improvement in every area of human activity.

Note, however, that in a market economy extensive *cooperation* occurs alongside intense competition. Most businesses exist within dense networks of customers, suppliers, consultants, and associations to allow them to trade information and learn from others’ successes and failures. Governments can encourage both cooperation and competition by eliminating unnecessary regulations preventing businesses from operating in the most efficient manner. For example, until the 1980s, antitrust rules often prevented businesses from cooperating on shared research and development projects. A free and open economy should allow such cooperation as long as it operates alongside intense competition and open entry of new industry challengers.

Studies examining the factors for the success of California’s Silicon Valley have noted that cooperation and competition have worked side by side in the rapid growth of the region. For example, voluntary agreements on complex technical standards for high-technology



products have been a crucial source of cooperation between businesses in Silicon Valley.<sup>3</sup> Such agreements can involve thousands of industry professionals coordinated across many committees and associations. Commonly accepted technical standards have also been a boon to competition because they have greatly aided small and specialized firms. A free economy allows both cooperation and competition to maximize economic growth and opportunity.

## **D. Openness to International Trade and Investment**

International trade makes it possible for businesses to specialize in products that they are best at making. Trade enables people to use revenue from their products to purchase goods produced more efficiently by others. Specialization and trade are mutually advantageous between individuals and across countries. Open trade ensures competitive markets, generates gains from economies of scale, and promotes the rapid diffusion of new innovations.

Openness to trade plays a crucial part in improving living standards. Imagine how wasteful it would be if each of the fifty states had to grow its own oranges or produce its own automobiles. It is far more efficient for Florida to grow oranges and Michigan to make automobiles, and then engage in trade. A key factor in American economic success is the large free trade zone that exists among the fifty states. Just as domestic trade generates higher incomes, greater international trade makes it possible for citizens in all countries to achieve higher living standards.

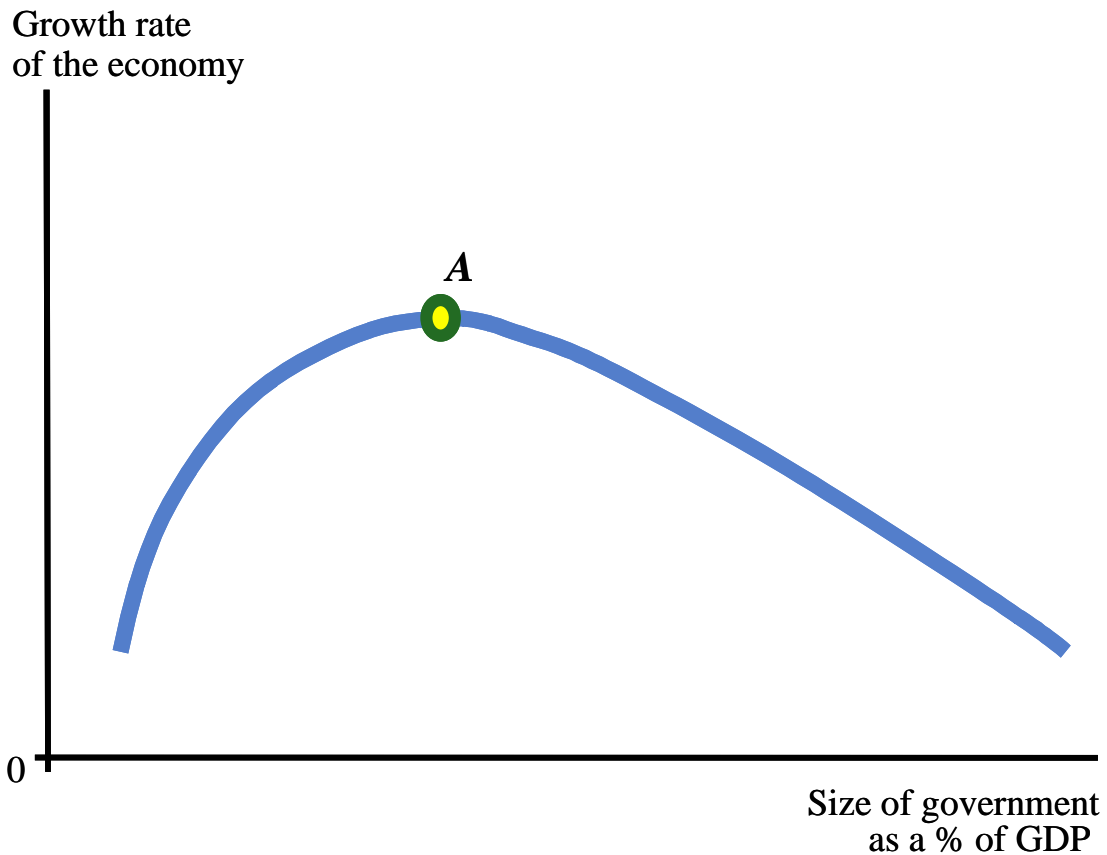
Like international trade, flows of international investment do much to raise living standards worldwide. They raise the quality and efficiency of production in every country, reduce the monopolization of domestic markets, and allow all countries to share in advances that foreign businesses discover. Portfolio investment flows, which occur when an American buys Honda stock, provide capital to countries in need of investment funds. Direct investment flows, which occur when Honda builds a car plant in the United States, allow countries to learn innovative production techniques from each other. When Japanese automobile makers began building factories in the United States two decades ago, U.S. workers, managers, and engineers learned from Japanese production strategies. No country leads in every industrial or technology area; as a result, openness foreign investment and trade are crucial avenues for the United States to learn about advances made abroad.

## **E. Limited Government**

Governments can enhance growth by providing a basic infrastructure for the smooth operation of markets. Some basic government functions include a legal system that protects people and property and a monetary system that provides price stability. In addition, governments may enhance growth by providing a limited set of goods—called public goods—that are difficult to supply through markets. Examples include national defense, flood control, and air and water quality. Government spending on such items as basic education can also enhance living standards and economic growth. As noted, government provision of basic goods and services up to a point enhances economic growth, after which expanding

## Exhibit 2: The Size of Government Versus Economic Growth

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government further retards growth. Exhibit 2 illustrates the relationship between the size of government and economic growth, assuming that government undertakes the most beneficial activities first. As the size of government expands, the growth rate of the economy initially increases. However, as government grows larger (to the right of point A), it spends more on activities that yield fewer benefits and economic growth falls. Expanding government beyond point A retards growth.

A government that grows larger than required to provide basic services may retard economic growth in a number of ways. First, as government grows large relative to the private sector, the returns to government activity diminish. The larger the government, the greater its involvement in activities it does poorly.

Second, more government means higher taxes or borrowing. Taxes and borrowing drain money from the private sector. Every dollar spent by government, no matter how important the program, destroys a similar private-sector activity, such as the purchase of new machines by businesses or the purchase of groceries by an average family.

Third, compared to the private sector, government is less innovative and less responsive to change. In the private sector, entrepreneurs have strong incentives to discover new and improved technologies and management methods. They are also in a position to act quickly as new opportunities arise. In government, the political process lengthens the time required to modify bad choices, such as ending ineffective programs. As the size of government expands, the sphere of innovative behavior shrinks.

Finally, as government grows, it becomes more heavily involved in redistributing income and in regulatory activism. These activities induce people to spend more time seeking favors from the government and less time producing goods for consumers. As government becomes larger, “political entrepreneurs” become more powerful, and market entrepreneurs are squeezed out.

Various studies have measured how excessive government reduces growth. A study of member countries of the Organization for Economic Co-operation and Development (OECD) found that a 10-percentage point increase in government spending is associated with a 1-percentage point reduction in annual economic growth.<sup>4</sup> Countries that have restrained the size of government and have promoted price stability and free trade have persistently achieved solid growth. This mix of policies has been the key to the strong economic performance of the United States during the 1980s and 1990s.

## **II. The Prelude to Reagan: The U.S. Economy in the 1970s**

During the 1970s, the U.S. economy was plagued with inflation and economic instability. It performed poorly because of external events, such as the crude oil price hikes of 1973 and 1979, but also because of policy errors made in Washington. At the time, many economists and policymakers mistakenly believed that governments could fine-tune fiscal and monetary policy to guide the private economy. They also mistakenly believed that governments should micromanage important industrial sectors such as energy and transportation. The result was that federal policies exacerbated economic crises, created more problems than they solved, and generated stop-go economic growth.

### **A. High Inflation**

In the 1960s and 1970s, many economists and policymakers, following Keynesian theory, erroneously believed there was a tradeoff between inflation and unemployment. They thought unemployment could be reduced if we followed an expansionary monetary policy and were willing to tolerate a little more inflation. The collapse of the Bretton Woods system from 1971 to 1973, precipitated by the United States, ended the gold standard as a restraint on monetary policy. Inflation rose from the low single digits characteristic of the gold standard to 11.0 percent in 1974 and 13.5 percent in 1980. However, high inflation did not reduce unemployment: the unemployment rate, which had averaged 4.7 percent from 1950 to 1970, averaged 6.4 percent from 1971 to 1980.

Rather than address inflation by reducing the growth of the money supply, successive administrations tried flawed approaches such as wage and price controls, which made economic conditions worse. As Jack Kemp has recalled, “Conventional economists were calling for a tax increase to dampen inflation by reducing consumer demand and for the Fed to use easy monetary policy to offset the ‘fiscal drag’ to prevent a recession.”<sup>5</sup> Keynesian theories were incorporated into such legislation as a 10-percent surtax on high incomes in 1968, and the Full Employment and Balanced Growth Act of 1978, which tasked the Federal Reserve to reduce unemployment.

Today, most economists and policymakers recognize that governments cannot make such carefully calibrated tradeoffs to improve the economy. In particular, monetary policy cannot permanently reduce unemployment by creating inflation. Monetary policymakers lack sufficient information to adjust policy to smoothly prop up the economy in a slowdown because there is a long lag between when a policy is chosen and when it begins to take effect. Furthermore, changes in economic conditions are often the result of unforeseen economic shocks such as droughts, wars, political revolutions, and financial crises. We cannot forecast such shocks, and monetary policymakers cannot accurately adjust for them in advance. In fact, badly timed attempts at stabilization can make the economy less stable by creating confusion about the goals of monetary policy. Most economists now believe that monetary policy should focus on price stability to maximize growth and foster general stability in output and employment.

## **B. A High and Rising Tax Burden**

Rising tax burdens provoked a tax revolt by Americans in the late 1970s and early 1980s. The top rate of the federal income tax was a punishing 70 percent. State and local taxes took away part of the rest. Such high rates discouraged investment and business growth and encouraged tax shelters and other activity whose productivity was low.

But what made the tax revolt of the 1970s a broad-based movement was not just high rates; “bracket creep,” which drove people into higher tax brackets because the tax code was not indexed for inflation, was equally important. Bracket creep was especially pronounced for income taxes. As incomes rose from inflation, people were automatically thrown into higher tax brackets even though their wages were barely keeping pace with inflation. During the 1970s the real burden of taxes was rising substantially every year, without any explicit increase in taxes by Congress. As one observer remarked:

This bracket creep mugged middle-income taxpayers to a staggering extent. A family of four whose income went up from \$15,000 to \$16,500 in 1980 just to keep up with a 10-percent inflation rate had a 23-percent increase in federal taxes...In 1970, a family earning \$25,000 was in the 28 percent income tax bracket. By 1982, that family needed nearly \$61,000 to maintain the same standard of living but that put them into the 49 percent tax bracket.<sup>6</sup>

It has been estimated that by the end of the 1970s, nearly 80 percent of families were paying higher taxes because of bracket creep.<sup>7</sup> Many more Americans were getting pushed into tax brackets with high marginal rates, and the situation was getting worse each year. Inflation of 10 percent, for example, pushed up federal tax revenues about 17 percent.<sup>8</sup> Average annual growth in federal individual income taxes collected was 12.7 percent a year from 1971 to 1981, and in two years the increase exceeded 20 percent. Income taxes were finally indexed to inflation by the Economic Recovery Tax Act of 1981; indexation actually began in 1985.

Inflation also increased property values, generating higher local property tax assessments. Rising property taxes prompted a grass-roots movement to limit taxes. The flagship effort was California’s Proposition 13, passed by referendum in June 1978. The success of Proposition 13 influenced similar measures throughout the country. Twenty states passed limits like California’s.

## **C. Energy Shortages and Regulatory Failures**

In the 1970s, OPEC (the Organization of Petroleum Exporting Countries) was temporarily successful in driving up energy prices and hitting consumer wallets worldwide. OPEC’s manipulations of oil supplies were turned into a full-scale energy crisis in the United States because of price controls in energy markets. Rising oil prices hurt consumers, but long lines at gas stations and shortages of heating oil were the work of bad policy, not of markets. The energy shortages of the 1970s drove home the folly of excessive regulation, and generated

support for deregulating energy and other heavily regulated industries in the late 1970s and early 1980s.

The impact of deregulation can be seen by comparing the oil shocks of the 1970s to more recent episodes. Energy economist Robert Bradley notes that the shock to the supply of oil during the Persian Gulf War of the early 1990s was actually greater than during the 1973 and 1979 shocks caused by OPEC and the Iranian revolution.<sup>9</sup> But whereas in the 1970s, increases in the world price of oil resulted in shortages of gasoline and heating oil in the United States, nothing of the kind happened in the 1990s. The reason was that in the 1970s, price controls prevented markets from adjusting efficiently. The Reagan Administration's very first executive order, in February 1981, decontrolled oil prices. When the Gulf War oil shock came, markets were able to allocate oil free of the bureaucratic hindrances that had caused disruptions in the 1970s.

### **III. The Reagan Program**

In 1981, newly elected President Ronald Reagan and Treasury Secretary Donald Regan refocused fiscal and monetary policy away from attempts at short-term economic management and towards promoting stable, long-term growth. Reagan proposed deregulation, sharp cuts in federal taxes, and fighting inflation as his top priorities. Reagan's policy package was designed to increase incentives to work and save, encourage businesses to increase investment spending, and stimulate economic growth. These were fundamental changes that reflected a turning away from the intellectual framework that informed economic policy in the 1960s and 1970s. The Reagan economic program and its intellectual framework have continued to influence the policies of subsequent administrations, making the years since Reagan took office a continuous and distinctive economic era. The Great Expansion of the U.S. economy that began just before the start of 1983 has continued until today. It has been interrupted only by two quarters of mild recession in the early 1990s. That recession resulted in part from the slow-motion crisis in the savings and loan industry, whose roots lay in the years of high inflation before Reagan. At great short-term political cost, the Bush Administration bit the bullet and resolved the crisis, preserving for the long term the Reagan approach to economic prosperity. During the Great Expansion, subsequent administrations have maintained elements of the policy package first assembled by the Reagan Administration.

#### **A. Price Stability**

Chastened by the combination of high unemployment and high inflation during the 1970s, economists and policymakers began to fundamentally change their monetary policy views. In August 1979, President Jimmy Carter appointed Paul Volcker as chairman of the Federal Reserve Board. Under Volcker, the emphasis of monetary policy shifted toward constraining inflation and achieving price stability.

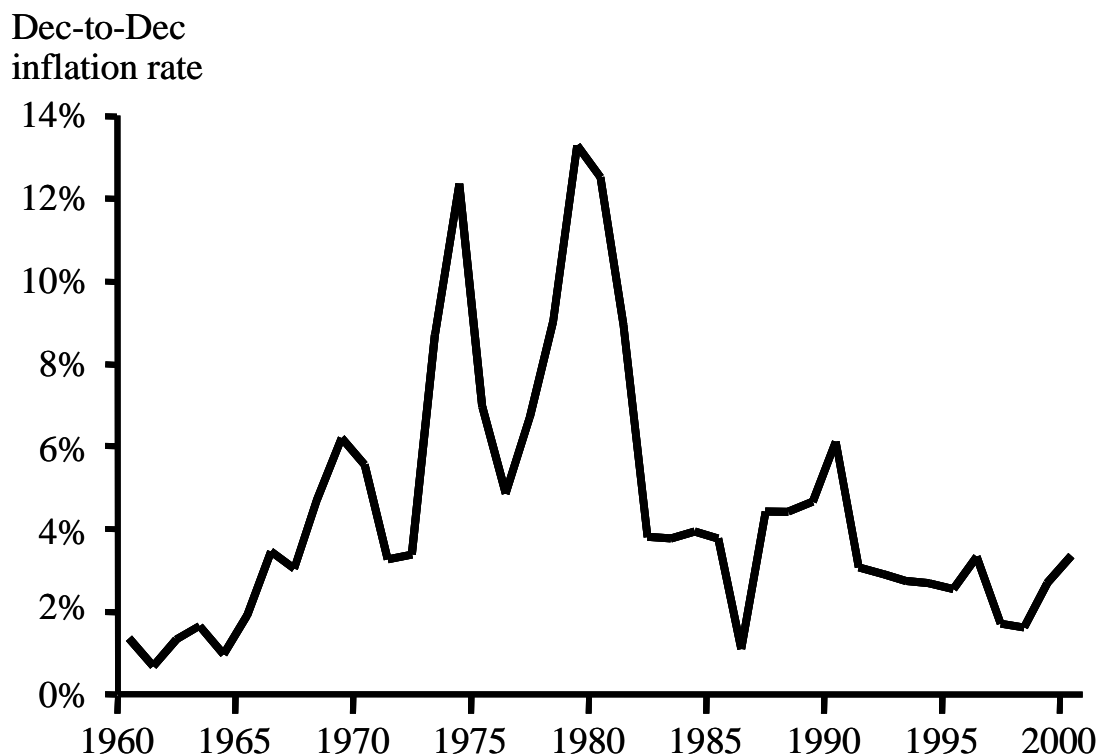
Efforts to use monetary policy to smooth ups and downs in the business cycle and keep unemployment low had led to substantial inflation and economic instability during the 1970s. Many economists and policymakers had erroneously believed that inflation could be controlled by fiscal policy changes such as tax increases.<sup>10</sup> These ideas did not solve inflation, and created inefficiency and instability in the economy to boot.

The Reagan Administration brought monetarist thinking to the forefront of monetary policy. Monetarists believed that monetary policy should focus on a single, well-defined objective: price stability. There was a growing understanding that price stability created the basis for sustained long-term growth and low unemployment. Under the chairmanships of Paul Volcker and Alan Greenspan, the focus of the Federal Reserve has been to reduce inflation and move toward price stability.

This policy has been highly effective. Exhibit 3 illustrates that the U.S. inflation rate has been both low and quite stable since the early 1980s. When inflation is low and stable, long-

### Exhibit 3: The U.S. Inflation Rate

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**Source:** Haver Analytics.

**Note:**\* The figures represented are based on December-to-December CPI-U measures. The most recent data point available (September 2000) is used as proxy for 2000.

term interest rates fall, lowering the cost of mortgages, business investment, and other long-term borrowing. Over time, people come to count on the greater price stability and adjust their choices and investment decisions accordingly.

Low inflation during the 1980s and 1990s has contributed powerfully to the strength of the economic boom. As time passed, confidence increased that the Federal Reserve would continue striving for price stability. This confidence has in itself kept the current expansion rolling along by lowering inflation expectations and keeping interest rates down. When the monetary authorities achieve price stability, they have done their part to enhance growth and prosperity. The Federal Reserve has performed extremely well during the last two decades in promoting price stability.

### B. Tax Cuts

When President Reagan took office in 1981, federal taxes were 19.6 percent of GDP, the second-highest level since World War II. The top individual income tax rate was 70 percent, and inflation was increasing the tax burden from bracket creep. Inflation and high marginal



tax rates were sapping business investment by reducing the value of depreciation allowances and reducing returns on capital purchases.

Policymakers during the 1960s and 1970s had focused on macroeconomic adjustments in their attempts to stimulate growth. The new Administration realized that the key to growth lay in microeconomic incentives rather than macroeconomic manipulations. The Reagan Administration's "supply-side" thinking focused on creating a hospitable environment for entrepreneurs, investors, and families by cutting high tax rates, reducing needless regulations, and providing stability in the monetary environment.

At Reagan's urging, Congress passed the Economic Recovery Tax Act of 1981, which reduced tax rates from their former range of 14 to 70 percent to a new range of 11 to 50 percent. To eliminate bracket creep, the act also provided inflation indexing for tax brackets, the standard deduction, and personal exemptions. The indexing rules became effective in 1985. To encourage businesses to invest, the act provided large increases in depreciation allowances and introduced an investment tax credit. It also provided a generous Individual Retirement Account (IRA) option to allow every family to save more for retirement. The capital gains tax rate was cut from 28 percent to 20 percent.

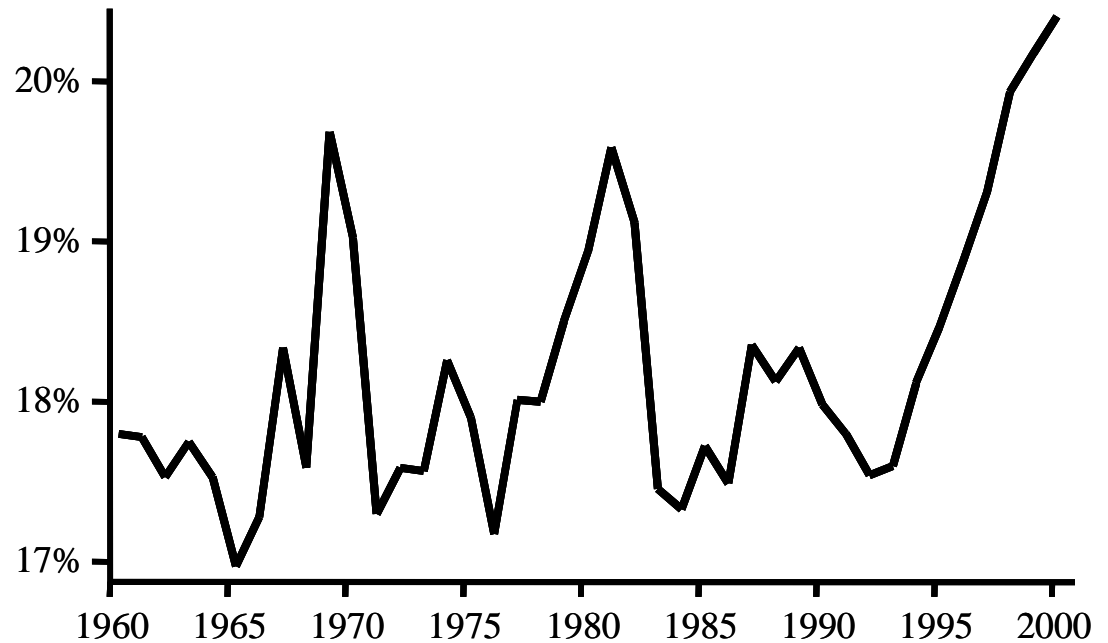
In 1985, the Reagan Administration proposed a further major tax overhaul that became the basis of the Tax Reform Act of 1986. This act cut marginal tax rates further and reduced the number of federal income tax brackets to only two: 15 and 28 percent. The act relieved millions of people from having to pay any income tax at all by increasing the standard deduction. The act also broadened the tax base and attempted to more fairly measure individual and business income. Its main thrust was to create a more neutral tax code, allowing the private sector to make efficient decisions without manipulation from Washington.

Reagan's tax cuts were preceded by a capital gains tax cut in 1978 advocated by the House Ways and Means Committee and unsuccessfully resisted by the Carter Administration.<sup>11</sup> The capital gains rate for individuals was cut from 49 percent to 28 percent in 1978, and then cut to 20 percent under Reagan in 1981. These cuts helped spur the growth in the U.S. venture capital industry. Aided by 1978 regulatory changes that allowed pension funds to place funds in higher-risk investments, venture capital investments soared from under \$1 billion per year in the late 1970s to over \$4 billion a year by 1983.<sup>12</sup> Venture capitalists invested in many early high-tech dynamos that have changed the shape of the U.S. economy, such as Apple Computer, Intel, and Genentech.

The tax cuts of the Reagan era increased incentives to work and save, thereby stimulating economic growth. While some tax rates have since been raised, rates are still substantially lower than they were before Reagan. For example, the top rate today on federal income taxes is 39.6 percent, versus 70 percent before Reagan. In addition, the Reagan tax cuts have been emulated around the world as other countries realized that high marginal rates dampen economic growth, discourage entrepreneurial activities, and reduce productive business investment.

## Exhibit 4: Federal Government Revenues

Federal revenue  
(share of GDP)



Sources: *Budget of the United States Government*, 2001; and Haver Analytics.

As Exhibit 4 shows, under Reagan federal taxes fell from 19.6 percent of GDP in 1981 to a low of 17.3 percent in 1984. In the 1990s they have shot up again, exceeding 20 percent of GDP by 2000. It is time again for a Reagan-style approach to reduce federal taxation.

### C. Changing Budget Priorities

Upon entering office, President Reagan proposed an unprecedented \$41 billion reduction in federal outlays for fiscal year 1982 and \$467 billion over five years. (These were reductions compared to the projected “baseline” increases. Given the political constraints of early 1980s, similar to those of today, it was difficult to reduce actual dollars spent.) Reagan believed domestic spending had become bloated by years of ceaseless expansion. He proposed overhauling entitlements, eliminating unessential and ineffective federal programs, consolidating 100 grant programs into fewer flexible block grants, and sharply reducing subsidies to business.

While determined to cut bloated domestic spending, Reagan also knew that the United States had to build up its defense forces after years of neglect. Reagan's first budget called upon Congress to boost defense spending by \$168 billion over five years. Despite this large proposed increase, Reagan's original budget proposal was cautious: it would have reduced outlays about 1.5 percent a year for five years relative to the projected baseline at the time.

In the last year of the Carter Administration and the first six months of the Reagan presidency, both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) were predicting a balanced federal budget by 1983 and large budget surpluses thereafter.<sup>13</sup> Former CBO director Robert Reischauer has written, “In its February 1980 report...CBO projected that revenues collected under current tax law would climb from about 21 percent of GNP in 1981 to 24 percent by 1985. Simple arithmetic pointed to enormous surpluses in the out-years. For example, current-law revenues exceeded outlays by a projected \$98 billion for 1984 and \$178 billion for 1985. Similarly, in July 1981...CBO projected budget surpluses of between \$148 billion and \$209 billion for 1986, depending on the economic assumptions used.” CBO considered those sizeable surpluses to be economically dangerous. “Before the enactment of ERTA [the 1981 tax act],” noted Reischauer, “CBO’s budget reports routinely warned that a continuation of current tax and spending laws would lead to a surplus that would act as a drag on the economy.”<sup>14</sup>

Faced with the prospect of large budget surpluses, the new Administration considered its proposed combination of tax cuts, reductions in nondefense spending, and increases in defense spending to be a prudent course that would retain balance in federal finances. President Reagan favored tax cuts partly because he understood that if large surpluses materialized, Congress would want to spend them. Congress was eager to accommodate, and ended up passing larger tax cuts than suggested by the Reagan Administration.

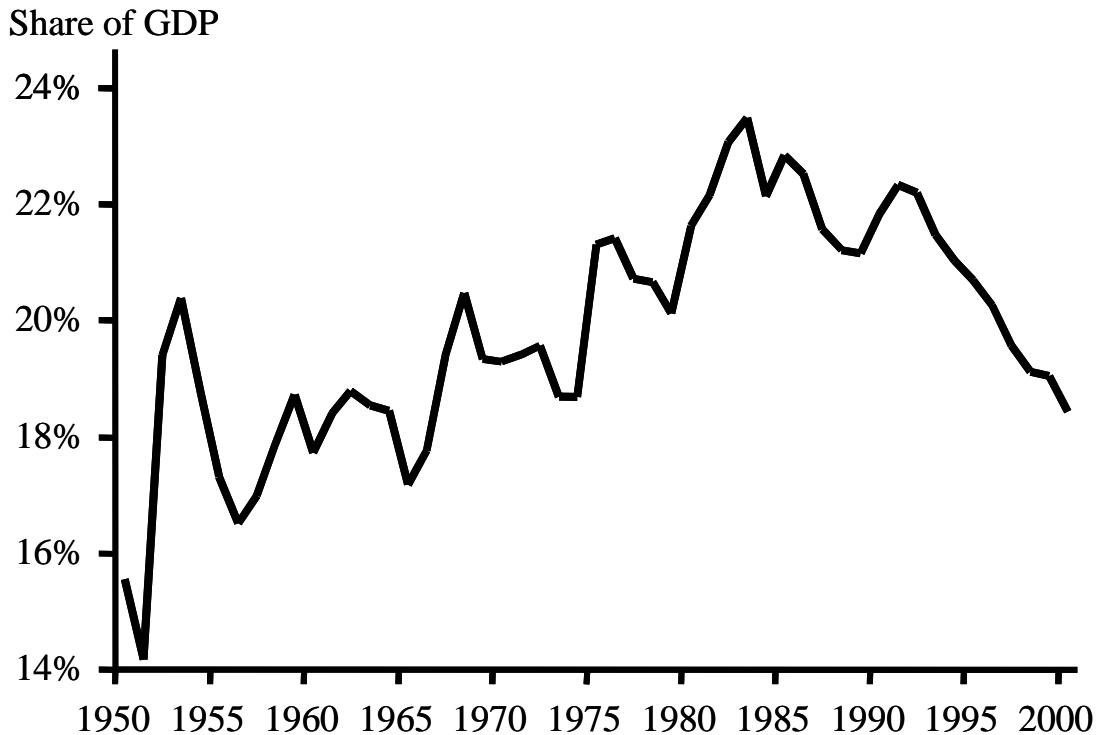
There was strong opposition to Reagan’s tax cuts from believers in outmoded economic theories, who thought tax cuts would aggravate inflation. In early 1981, *The New York Times* warned that Reagan’s economic program could be “one of the most calamitous, inflationary failures of all time.” The former chairman of Lyndon Johnson’s Council of Economic Advisors told Congress “it would be a miracle” if inflation fell under the Reagan program.<sup>15</sup>

As it turned out, inflation plummeted from 12.5 percent in 1980 to 3.8 percent by 1982, as the Federal Reserve’s tight monetary policy bit. The Reagan Administration assumed inflation would fall, but far more slowly. And because the tax code was not yet indexed for inflation, the government’s revenue estimates were particularly sensitive to changes in the inflation rate. The sudden fall in inflation and the recession it caused made tax revenue lower than projected. The result was unexpected budget deficits. Some pundits were quick to blame the deficits on Reagan’s policies. But, as Robert Reischauer has noted, “Given the best information available at the time [1981], the Congress and the Administration reasonably thought that significant budget surpluses loomed under current law....It is reasonable to ascribe nearly all of the underestimate of deficits during this period to errors in economic forecasts.” It should also be noted that except in fiscal 1984, federal outlays exceeded the amounts the Reagan Administration recommended.<sup>16</sup>

Progress was made during the mid and late 1980s in restraining federal spending. As Exhibit 5 illustrates, there had been an upward trend in federal spending as a share of GDP from 1950 to 1983, when it peaked at 23.5 percent. Spending was wrestled down to 21.2 percent by fiscal 1989. In addition to the Reagan Administration’s efforts, Congress erected hurdles to deter spending, including the Gramm-Rudman-Hollings Act of 1985 and

## Exhibit 5: Federal Government Expenditures

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**Sources:** *Budget of the United States Government*, 2001; and Haver Analytics.

amendments in 1987. Nondefense spending peaked in fiscal 1983 at 17.4 percent of GDP; by fiscal 1989 it was 15.3 percent of GDP.

President Reagan also made progress in bringing growth in the federal bureaucracy under control. Upon coming into office, he ordered an immediate freeze on federal hiring. In two years, his administration trimmed nondefense federal employment by more than 100,000 persons. Despite some upward drift after 1986, nondefense federal employment was 6 percent lower at the end of Reagan's presidency than at the start.

One budget legacy of the Reagan Administration is the rise and subsequent fall in defense expenditures. While the defense build-up of the 1980s was a burden on the American taxpayer, the policy achieved its goal when the Soviet Union crumbled and the Cold War was won. When the Reagan Administration took office, the tide of Communism was at its high-water mark. Soviet troops were occupying Afghanistan, and Soviet-supported regimes in Eastern Europe, Nicaragua, Angola, Mozambique, and elsewhere were a constant threat to freedom.

Higher defense spending in the 1980s proved to be an excellent investment. Americans are now enjoying the peace dividend from Reagan's defense build-up as defense spending has fallen in the 1990s with reductions in U.S. military forces. Defense spending fell from 6.2

percent of GDP in fiscal 1986 to 3.1 percent of GDP in 1998. More than 2 million jobs shifted out of defense-related industries between 1989 and 1993. In the short run, this caused a contraction of an important economic sector. By the mid 1990s, however, the economy had adjusted, and the talents of former defense workers in computers, engineering, and other fields were contributing to its strength.

## **D. Deregulation**

Before the 1980s, a common theme in economic policymaking was the application of interventionist “solutions” to economic problems. On the macroeconomic front, the stagflation of the 1970s had been exacerbated by policymakers trying to fine-tune the economy. Wage and price controls did not solve the underlying problem of excessive money supply growth, and they created new problems such as shortages of controlled products.

On the microeconomic front, heavy-handed regulation of major industries was supposed to help consumers, but usually ended up doing the opposite because it restrained competition and prevented new firms from challenging entrenched companies. Economists and policymakers began to reassess the costs of excessive regulations, and a movement towards deregulation that began in the late 1970s gained steam under President Reagan.

By the end of the 1980s, substantial deregulation had occurred in airlines, trucking, intercity buses, natural gas, oil, telecommunications, financial services, and shipping. Deregulation had important impacts that continue to this day. The break-up of AT&T in 1984, for example, led ultimately to the Internet explosion of the 1990s as it created a multiplicity of telecom firms, each pursuing unique innovations that Ma Bell would never have stumbled upon. Companies such as Federal Express and MCI would not have been able to revolutionize the economy as they did if the old command and control regulations were still in place.

In transportation, deregulation begun in the 1970s continued under the Reagan Administration. The 4-R Act of 1976 and Staggers Act of 1980 removed regulations that were paralyzing the ability of railroads to compete against other forms of transportation. The Airline Deregulation Act of 1978 allowed airlines to change routes and gave them greater flexibility in setting fares, creating the conditions for discount fares, frequent flyer programs, and other innovations. The Motor Carrier Act of 1980 deregulated the trucking industry. The Bus Regulatory Reform Act of 1982, signed into law by President Reagan, allowed intercity bus companies to change routes and fares without government intervention. The Shipping Act of 1984 allowed individual shipping companies to lower prices and provide better service than so-called shipping conferences, which acted like cartels.

In energy, the Reagan Administration moved quickly to deregulate an industry that had been heavily regulated in the 1970s. Federal controls had covered nearly all aspects of oil production, refining, and distribution. Presidents had had discretion to set wages and prices, to allocate crude oil and petroleum products, and to eliminate “windfall” profits. Within a month of coming to office in January 1981, President Reagan removed all and price controls and allocation restrictions on oil. With one stroke, he eliminated a large government bureaucracy

## Exhibit 6: Consumer Benefits of Deregulation

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<b>Industry</b>	<b>Year deregulated</b>	<b>Real price reduction after 10-years</b>	<b>Annual consumer benefits</b>
Airlines	1977	29%	\$19.4 billion
Railroads	1980	44%	\$9.1 billion
Trucking	1980	28% - 56%	\$19.6 billion
Natural gas	1984	27% - 57%	n/a
Long-distance phone	1984	40% - 47%	\$5.0 billion

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**Source:** Robert Crandall and Jerry Ellig, "Economic Deregulation and Customer Choice: Lessons for the Electric Industry," Brookings Institution and Center for Market Processes, 1997.

supervising an inefficient system that hurt both producers and consumers. In 1982 Reagan vetoed a bill that would have given the President the power to set oil prices and allocate supplies in a shortage, thus short-circuiting an attempt to re-regulate the oil industry.

Natural gas was another heavily regulated industry, whose output was also subject to federal price controls. The Reagan Administration removed price controls on natural gas other than caps on the "field" price, and in 1986 it increased the price ceiling on the remaining "old" gas above the market-clearing price. This created *de facto* deregulation and prompted Congress to pass legislation ending price controls on natural gas.

Two decades of experience with industry deregulation have conclusively shown that open competition has been a great boon to the American economy and consumers. Exhibit 6 shows calculations of the benefits of deregulating major industries.<sup>17</sup> In all cases, prices have plummeted, saving consumers billions of dollars every year.

A recent study by the Organization for Economic Cooperation and Development looking back on the U.S. deregulation experience concluded:

[T]he removal of most restrictions on pricing, entry and exit in network industries led directly to increased productivity and lower costs....More vigorous competition stimulated industry restructuring and innovation and benefited consumers through better service and lower prices....An extraordinary surge in innovation and faster introduction of new technologies, services, and business practices multiplied benefits for consumers and produced new high growth industries....These effects allowed the US economy to adapt more quickly to changes in technology and to external shocks, improved the trade-offs between inflation, growth, and unemployment, and boosted the US lead in technology.<sup>18</sup>

In addition to deregulation of particular industries, the Reagan Administration worked to reduce the rapid and never-ending accumulation of regulatory decrees issued by every agency in Washington. Professor Murray Weidenbaum, a member of Reagan's economic team, remembers what the incoming president was up against: "The 1970s will be remembered for an outpouring of federal rules and expansion of regulatory agencies that resulted in greater intervention in the private economy." While deregulation of some industries had begun in the late 1970s, many regulatory agencies were still growing. Weidenbaum estimates that the number of federal regulators grew from fewer than 70,000 in 1970 to about 122,000 by 1980.<sup>19</sup>

Soon after coming to office, President Reagan issued an executive order mandating federal agencies to demonstrate that the benefits of proposed new regulations surpassed their costs. The Office of Information and Regulatory Affairs, created in 1981 as part of the Office of Management and Budget had the responsibility to enforce that order and perform the regulatory reviews required by President Reagan. Under Reagan, the government created no new regulatory agencies, nor did it substantially expand any major regulatory programs. The contrast with the records of other administrations is sharp.

Reagan made progress changing the culture of regulation in Washington.<sup>20</sup> The annual listing of regulations published in the *Federal Register* peaked at 73,000 in 1980, and fell to 50,000 through the mid and late 1980s. (In 1999 the number of pages was almost 74,000.)<sup>21</sup> Figures on the total compliance costs of federal regulations show a similar downward trend during the Reagan years. The number of federal regulators, which had peaked at 122,000 in 1980, was reduced to 102,000 by 1985, but started to rise thereafter. Recent efforts to "reinvent government" have seen the number of regulators climb past 130,000.<sup>22</sup>

## **E. Free Trade**

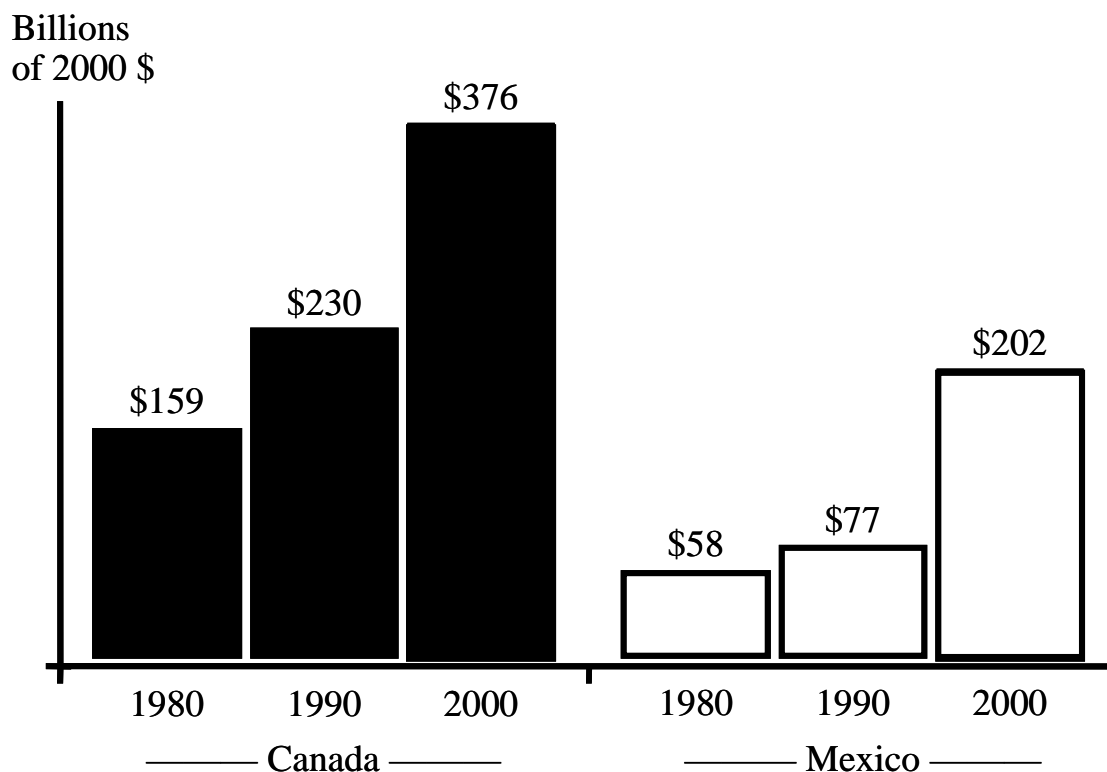
Freedom to trade within nations is taken for granted. In the United States, provisions of the Constitution ensure open trade between the fifty states. Unlike the case at the domestic level, at the international level the rationale for free trade needs to be restated frequently. The Reagan Administration pursued freer trade in a number of areas, and fought protectionist pressures that plagued the policy environment of the 1980s.

In 1982, President Reagan proposed the Caribbean Basin Initiative, which Congress approved the following year. The initiative unilaterally reduced or eliminated U.S. tariffs on many imports from 24 countries in and around the Caribbean. By strengthening the economies of the region, the United States has benefited both economically and strategically, by promoting security and democracy close to home.

The United States signed bilateral free trade agreements with a number of countries. The first was with Israel, in 1985. Then the Reagan Administration moved on to negotiate an agreement with Canada, by far our nation's largest trading partner. The agreement was

## Exhibit 7: U.S. Trade with Canada and Mexico

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**Source:** International Trade Administration internet site, <http://www.ita.doc.gov>.

**Note:**\* Real values are base 2000 – q2 (using CPI-U).

ratified in 1989. Trade between the United States and Canada remains the largest between any two countries in the world, and has accelerated since the agreement took effect.

The U.S.-Canada agreement led directly to the North American Free Trade Agreement (NAFTA) passed in 1993. The Reagan Administration had developed a framework of understanding with Mexico that provided a basis for later negotiations and ultimately for the three-way signing of NAFTA. NAFTA is having a dramatic effect on Mexico's economy and is creating another strongly democratic, increasingly dynamic economy on our southern border to match Canada in the north. Mexico recently surpassed Japan to become America's second-largest trading partner. Exhibit 7 illustrates the growth of U.S. trade in goods and services with Canada and Mexico. In the last two decades, trade with Canada has more than doubled, while trade with Mexico has almost quadrupled.

The "Uruguay Round" of the General Agreement on Tariffs and Trade, a huge multilateral negotiation, was launched in 1986. Because it involved more than 100 countries, the negotiation took many years; the Uruguay Round agreement ultimately took effect in 1994. Perhaps its most important component was the General Agreement on Trade in Services, which reduced barriers to trade in such dynamic sectors as financial services,



communications, and business consulting. The Uruguay Round also addressed agricultural protectionism.

## **F. International Influence of the Reagan Revolution**

The Reagan Administration's policies of lower tax rates, deregulation, free trade, and low inflation had effects far beyond the borders of the United States. They created a profound change in economic thinking around the world that continues to this day. Along with the similar reforms undertaken by Britain under Margaret Thatcher, the Reagan policies demonstrated that giving people greater economic freedom was the key to creating new jobs and raising standards of living.

In 1980, the top marginal tax rate was at least 60 percent in 19 of 20 developed countries. By 1990, only 6 of the 20 developed countries had such a high top rate. Many developing countries also cut tax rates. Countries besides the United States that enacted dramatic rate cuts since the 1980s include: Britain (where the top rate fell from 83 percent to 40 percent), New Zealand (60 percent to 33 percent), Bolivia (48 percent to 10 percent), Brazil (55 percent to 25 percent), Jamaica (80 percent to 33 percent), and Singapore (55 percent to 33 percent).<sup>23</sup>

Deregulation and privatization have become worldwide phenomena since the 1980s. Other countries imitated U.S. deregulation of transportation and communications. Many countries privatized banks, railroads, airlines, telephone systems, electricity generation, oil companies, steel mills, and many other businesses that were already private in the United States. Formerly inefficient government monopolies became efficient private competitors providing services at lower total cost to customers. After communism collapsed from 1989 to 1991, postcommunist governments began applying principles of deregulation and privatization to reshape their economies from top to bottom.

In the 1970s the United States tolerated double-digit inflation, endangering the dollar's role as the leading international currency. The decisive way the United States adhered to a policy of low inflation in the 1980s restored the dollar's pre-eminence and emphasized the importance of sound money. It is now generally acknowledged throughout the world that monetary policy should emphasize price stability.

The policies of the Reagan Administration had worldwide impact because other countries realized they would have to adopt similar policies or fall behind America's lead. By being both an example and a competitive threat to other countries, the policies of the Reagan Administration accelerated the spread of economic freedom internationally.

## IV. The Great Expansion, 1983-2000

### A. Low Inflation, High Growth, and Rising Employment

Today, the United States continues to enjoy the Great Expansion, a period of economic growth since 1983 that was interrupted by only two quarters of mild recession in the early 1990s. During this period, real GDP has expanded an average of 3.6 percent a year, employers have created more than 35 million new jobs, and the Dow Jones Industrial Average has grown an average of 15 percent a year. Strong economic growth has raised incomes for Americans in every income and demographic group. Growth has balanced the federal budget and may generate large surpluses for years to come.

As Exhibit 8 shows, the economic record of the last 18 years is remarkable. The United States has experienced two of the longest and strongest expansions in our history back-to-back. The years from 1983 are best viewed as a single expansion, with its roots in the policy

### Exhibit 8: The Great Expansion, 1983-2000

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	<b>1983-90*</b> <b>expansion</b>	<b>1991-2000*</b> <b>expansion</b>	<b>Entire</b> <b>period*</b>
<b><i>Real GDP</i></b>			
Total growth	35.6%	36.4%	85.5%
Average annual growth	4.1%	3.4%	3.6%
<b><i>Real GDP per person</i></b>			
Total growth	26.7%	24.8%	57.1%
Average annual growth	3.2%	2.4%	2.6%
<b><i>Employment</i></b>			
Total growth	19.9 mil.	17.4 mil.	36.1 mil.
<b><i>Dow Jones Industrial Average</i></b>			
Average annual growth	14.5%	15.9%	14.8%

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**Sources:** Industrial production data from *Economic Report of the President, 2000*, and the Department of Commerce website, <http://www.doc.gov>. Dow Jones Industrial Average data are quarterly averages from Economagic.com. Changes in real GDP and consumption are based on figures for 4-quarter moving averages, derived from data extracted from Haver Analytics.

**Note:\*** The 1983-90 expansion is measured from 1982:q4 - 1990:q2. The 1991-00 expansion is measured from 1991:q2 - 2000:q2. "Entire period" includes recession quarters.

changes of the late 1970s and early 1980s.

The Great Expansion has lasted so long in part because growth in productivity has been strong. Productivity growth is vital to long-term increases in the standard of living. Deregulation, increased global competition, and the enormous investments that American businesses and workers have made in new technologies are making the economy ever more efficient. Unlike the expansions of the 1960s and 1970s, the Great Expansion is not the result of policies stimulating short-term demand. In the 1960s and 1970s, policies to stimulate demand often led to inflation, provoking policymakers to depress demand to bring inflation back under control. This stop-go strategy was discarded in the 1980s. Since then, monetary policy has focused on price stability as its top priority.

The current level of price stability is the best the United States has achieved since the early 1960s. Lower inflation has translated into lower interest rates. Although the Federal Reserve recently acted to nudge short-term rates higher, long-term rates are generally lower than they have been during the last three decades. Lower inflation and interest rates have fostered economic growth. As discussed, this strategy has been very successful, not just in terms of creating low inflation but also in allowing the private sector to maximize growth. Alan Greenspan noted in 1999 that, “If nothing else, the experience of the last decade has reinforced earlier evidence that a necessary condition for maximum sustainable economic growth is price stability.”<sup>24</sup>

From a historical perspective, the stability of the economy has been unprecedented during the Great Expansion. While individual industries have been very dynamic and rapidly changing, Exhibit 9 shows that the amount of time the U.S. economy has spent in recession has declined from 44 percent during the period 1855-1909 to only 4 percent since 1982. The U.S. economy has spent less time in recession since December 1982 than in any comparable period in history.

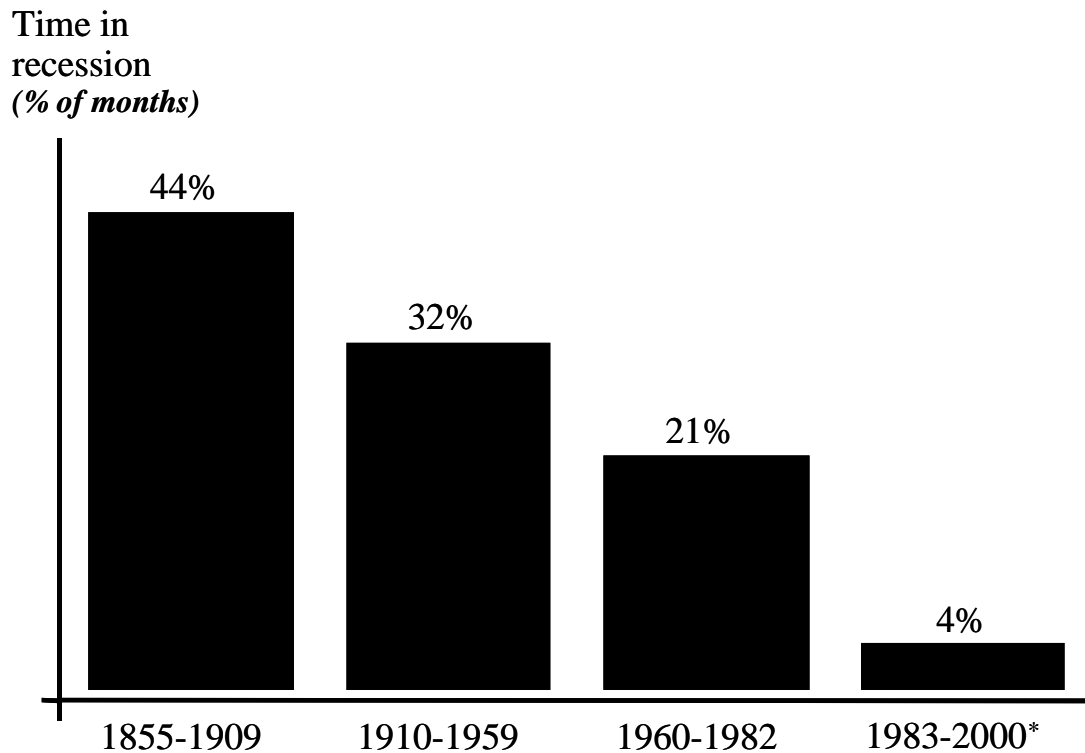
The international economy is improving, with most major economies now achieving sustained growth. Most of our trading partners have better prospects for growth today than they have had for years. One cloud in the sky is the big jump in the price of oil, which threatens to reduce economic growth worldwide. However, because of the greater strength and flexibility of the U.S. economy today, we are in a better position to weather any adverse consequences than we were in the 1970s.

## **B. The Growing Strength and Dynamism of U.S. Business**

This report has discussed how the failure of interventionism in the 1970s paved the way for a new set of economic policies under the Reagan Administration. At the same time that the government’s ability to fine-tune the economy was being questioned, American business stability was upset in industry after industry. Scores of upstart entrepreneurs were challenging seemingly unassailable giants such as AT&T and IBM. The rapid birth of new entrepreneurial businesses and continuous restructuring by America’s largest corporations has remade the American business landscape in the past two decades. Many once-stable industries such as

## Exhibit 9: Increased Stability of the U.S. Economy

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**Source:** Federal Reserve Bank of San Francisco *Economic Letter* 99-16, May 14, 1999.

**Note:** \*Final period ends with September 2000.

steel, retailing, and financial services have seen enormous change as increased competition has forced companies to produce better products at lower costs.

With the United States in the lead, industrial countries are undergoing a fundamental shift away from a managerial economy towards an entrepreneurial economy. Economic activity has moved away from large corporations towards small and medium-size firms since the 1970s. The share of total U.S. employment represented by Fortune 500 firms has fallen substantially since 1970.<sup>25</sup> The cornerstones of the managed economy—stability, homogeneity, and economies of scale—are being replaced by greater turbulence, heterogeneity, and flexibility. These qualities of the new entrepreneurial economy can be seen in high-tech fields such as electronics, biotechnology, and the Internet.

Young entrepreneurial companies have been aided in their competitive challenges by technological advances and by revolutions in U.S. financial markets. Cheaper and faster computers, sophisticated software, and the Internet have allowed smaller ventures to gain the information advantages once held only by large firms. Innovations in financial markets have ensured that large pools of capital are available to risk-taking entrepreneurs. Markets for venture capital, high-yield bonds (misleadingly termed “junk bonds”), and initial public offerings (IPOs) have funneled billions of dollars to new ventures allowing them to test new

ideas and challenge entrenched firms. Efficient financial markets have allowed the United States to excel at growing small firms into the new giants of leading-edge industries.

The impetus for change in the American business landscape came both from policy changes in Washington, and from the new dynamism in the world economy. U.S. companies faced many new competitive threats from foreign companies in the 1980s. While there were many calls to build a Fortress America and protect U.S. producers from Japanese and German competition, the Reagan, Bush, and Clinton Administrations have generally resisted these calls. As a consequence, U.S. business is more competitive and efficient than ever, with the result that incomes are higher and real prices of goods are lower than ever for the average American family.

U.S. corporations have spent two decades restructuring and learning valuable lessons from foreign producers, and adopting techniques such as just-in-time manufacturing systems to improve quality. Openness to foreign investment has been greatly beneficial. Hundreds of Japanese and European firms have built U.S. factories and provided high-wage, high-skill jobs to American workers. U.S. business managers and engineers have been able to take lessons learned in foreign-owned plants and implement them in U.S. companies.

Private-sector restructuring and expansion have also been greatly aided by innovations in America's dynamic capital markets. Any growing economy must have a way of shifting capital away from old industries towards new and higher-valued ones. U.S. capital markets have played this role, efficiently funneling billions of dollars to entrepreneurs in high-growth industries. In a recent study, the Organization for Economic Co-operation and Development found that the flexible legal framework of U.S. capital markets has helped spur strong entrepreneurial economic growth.<sup>26</sup> The diversity of financing sources available to American entrepreneurs have meant that good ideas do not need the blessing of a government agency or corporate bureaucracy to reach the market.

In the 1980s, innovations in the market for high-yield bonds played a key role in remaking America's big corporations into more entrepreneurial firms. High-yield bonds provided a key source of financing for rapidly growing firms in telecommunications and other high-technology fields. High-yield bonds were also instrumental in financing buyouts and corporate restructuring efforts to make American corporate management more accountable. Managers in every corporation were forced to improve performance to avoid becoming a takeover target. *Forbes* magazine noted of the 1980s: "Attitudes in American business across the board had been changed by 2,385 leveraged buyouts worth a total of \$245 billion....These deals helped revolutionize corporate finance, create new incentives for efficient management, and inspire risk-taking on a grand scale."<sup>27</sup>

In the 1990s, a second front of entrepreneurial financing blossomed with the explosion of the venture capital industry in California's Silicon Valley. Deregulation and capital gains tax cuts helped the venture capital market take off in the early 1980s. This industry fed \$48 billion of equity risk capital to young technology companies in 1999, up from just \$2 billion in 1990. Since the 1970s, many of the dynamos of the U.S. high-tech industry have been

nourished with venture capital, including Apple, Lotus, Compaq, Intel, Yahoo, Sun, Genentech, Cisco, Amazon, and McAfee.<sup>28</sup>

In fact, the high-technology sector has played a starring role in the dynamic economic climate of the 1980s and 1990s. High-tech industries now account for more than 8 percent of U.S. GDP, up from 4.5 percent in 1980. U.S. software, semiconductor, biotechnology, pharmaceutical, and Internet-related companies dominate world markets. In addition to plentiful venture capital financing, U.S. high-tech firms have benefited from easy access to equity financing through the NASDAQ stock exchange. The NASDAQ now hosts hundreds of initial public offerings each year. The value of initial public offerings has risen from \$2 billion in 1990 to \$50 billion in 1999. NASDAQ has been a powerful competitive asset to U.S. entrepreneurs, who have excellent access to capital compared to rivals in more regulated foreign financial markets.

## V. Conclusions

When analyzing the factors underlying the Great Expansion of the past 18 years, it is clear that a major paradigm shift occurred between the 1970s and the 1980s. In the 1970s, economists and policymakers believed that governments could fine-tune macroeconomic policy, and that governments should take the lead in shaping industries and creating growth. Evidence mounted that these views were false, and the policymakers of the 1980s redirected economic policy toward creating a stable and hospitable environment for long-term growth led by the private sector. The policies they pursued included price stability, tax cuts, deregulation, and permitting dynamic innovation in the private sector.

The Reagan Administration was at the vanguard of these changes in economic thinking and policy. Ronald Reagan's faith in the inherent strength of individual Americans and businesses to plan for their own future contrasted sharply with the prevailing wisdom of prior decades. The remarkable growth of the American economy during the past two decades is a testament to the accuracy of Reagan's belief. The U.S. economy is so dynamic and strong today because government has gotten out of the way of individuals, entrepreneurs, and businesses seeking opportunity and expansion. The federal government did not plan, manage, or foresee the incredible advances that millions of free individual Americans have created in the past two decades.

Most of President Reagan's policies continue today, suggesting that the Great Expansion can continue well into the 21<sup>st</sup> century. Surprise shocks, such as the recent rise of world oil prices, will no doubt occur in the future with some impact on the economy. But the greater efficiency, diversity, and flexibility of today's economy makes it much more capable of dealing with such shocks in stride. And while the economy may be slowed by the occasional mild recession, rapid technological advances and high levels of entrepreneurship will keep the U.S. economy moving in a direction of discovery, growth, and higher incomes for years to come.

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## Appendix: Ronald Reagan in His Own Words

### A. The Role of Government

“Government’s first duty is to protect the people, not run their lives.” (Remarks, March 30, 1981)

“The main role of government is to provide a stable economic environment that allows each individual to reach his or her full potential. Individuals and businesses must be able to make long-run plans confident that the government will not change the rules halfway through the game. Government’s drain on the economy, both through its resources that could be used more productively by the private sector and through taxes that destroy individual incentives, must be minimized.” (Letter to the Speaker of the House and the President of the Senate, January 10, 1989)

“This idea that government was beholden to the people, that it had no other source of power, is still the newest, most unique idea in all the long history of man’s relation to man. This is the issue of this election: whether we believe in our capacity for self-government or whether we abandon the American Revolution and confess that a little intellectual elite in a far-distant capital can plan our lives for us better than we can plan them ourselves.” (Bill Adler, ed., *The Uncommon Wisdom of Ronald Reagan*, pp. 43-44)

“Government has an important role in helping develop a country’s economic foundation. But the critical test is whether government is genuinely working to liberate individuals by creating incentives to work, save, invest, and succeed.” (*The Uncommon Wisdom of Ronald Reagan*, p. 57)

“Now, so there will be no misunderstanding, it is not my intention to do away with the government. It is rather to make it work—work with us, not over us; to stand by our side, not ride on our back. Government can and must provide opportunity, not smother it; foster productivity, not stifle it.” (Inaugural Address, January 20, 1981)

### B. Freedom and Inalienable Rights

“Freedom is a fragile thing and is never more than one generation away from extinction.” (Speech, January 5, 1967)

“Our natural inalienable rights are now presumed to be a dispensation of government, divisible by a vote of the majority. The greatest good for the greatest number is a high-sounding phrase but contrary to the very basis of our nation, unless it is accompanied by recognition that we have certain rights which cannot be infringed upon, even if the individual stands outvoted by all of his fellow citizens. Without this recognition, majority rule is nothing more than mob rule.” (Speech, October 27, 1964)



“I had a copy of the Soviet Constitution and I read it with great interest. And I saw all kinds of terms in there that sound just exactly like our own: ‘Freedom of assembly’ and ‘freedom of speech’ and so forth. Of course, they don’t allow them to have those things, but they’re in there in the constitution. But I began to wonder about the other constitutions—everyone has one—and our own, and why so much emphasis on ours. And then I found out, and the answer was very simple. That’s why you don’t notice it at first, but it is so great that it tells the entire difference. All those other constitutions are documents that say that ‘We, the government, allow the people the following rights,’ and our Constitution says ‘We, the people, allow the government the following privileges and rights.’” (Remarks, February 5, 1981)

### **C. Economic Growth**

“There are no such things as limits to growth because there are no limits on the human capacity for intelligence, imagination, and wonder.” (Quoted in *Campaigns and Elections*, 1996)

“Freedom and incentives unleash the drive and entrepreneurial genius that are the core of human progress.” (Second Inaugural Address, January 21, 1985)

“Individual freedom and the profit motive were the engines of progress which transformed an American wilderness into an economic dynamo that provided the American people with a standard of living that is still the envy of the world.” (Remarks to the National Space Club, March 29, 1985)

“We who live in free market societies believe that growth, prosperity, and ultimately human fulfillment are created from the bottom up, not the government down. Only when the human spirit is allowed to invent and create, only when individuals are given a personal stake in deciding economic policies and benefitting from their success—only then can societies remain economically alive, dynamic, progressive, and free. Trust the people. This is the one irrefutable lesson of the entire postwar period, contradicting the notion that rigid government controls are essential to economic development.” (Remarks, September 29, 1981)

“Prosperity is something created by people and their industries and business for which government takes credit.” (Address as Governor of California, 1973)

“The economic welfare of all our people must ultimately stem not from government programs, but from the wealth created by a vigorous private sector. What is more just than allowing individuals to benefit from their work and talent?” (Statement to a French newspaper, December 22, 1983)

“If we look to the answer as to why for so many years we achieved so much, prospered as no other people on Earth, it was because here in this land we unleashed the energy and individual genius of man to a greater extent than has ever been done before.” (Inaugural Address, January 20, 1981)

“Some believe that government planning is more efficient, so they rely on tax breaks and other subsidies to those businesses that already exist. But that never works....[T]he most fertile and rapidly growing sector of any economy is that part that exists right now only as a dream in someone’s head or an inspiration in his heart. No one can ever predict where the change will come from or foresee the industries of the future.” (Address, June 5, 1987)

“What is euphemistically called government-corporate partnership is just government coercion, political favoritism, collectivist industrial policy, and old-fashioned Federal boondoggles nicely wrapped up in a bright-colored ribbon. And it doesn’t work. This kind of approach was tried in Europe, and it’s being abandoned, because it only resulted in economic stagnation and industrial decay.” (Remarks at a campaign fundraising luncheon for Rep. Connie Mack, June 29, 1988)

## **D. International Trade**

“Free trade serves the cause of economic progress, and it serves the cause of world peace.” (Radio address, November 20, 1982)

“We’re in the same boat with our trading partners. If one partner shoots a hole in the boat, does it make sense for the other one to shoot another hole in the boat? Some say yes, and call it getting tough. Well, I call it stupid. We shouldn’t be shooting holes; we should be working together to plug them up. We must strengthen the boat of free markets and fair trade so it can lead the world to economic recovery and great political stability.” (Radio address, November 20, 1982)

“I remain committed to the principle of free trade as the best way to bring the benefits of competition to American consumers and businesses. It would be totally inappropriate to respond by erecting trade barriers or by using taxpayers’ dollars to subsidize exports.” (*Economic Report of the President*, 1984)

## **E. Taxes**

“Raising taxes won’t balance the budget; it will encourage more government spending and less private investment. Raising taxes will slow economic growth, reduce production, and destroy future jobs, making it more difficult for those without jobs to find them and more likely that those who now have jobs could lose them.” (State of the Union Address, January 26, 1982)

“Our opponents want more money from your family budgets so they can spend it on the federal budget and make it remain high. Maybe it’s time that you and millions like you remind them of a few simple facts. It’s your money, not theirs. You earned it. They didn’t. You have every right to keep a bigger share than you’ve been allowed to keep for a great many years now.” (Remarks on the Program for Economic Recovery, June 11, 1981)

## F. Big Government

“Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.” (Remarks to the White House Conference on Small Business, August 15, 1986)

“Because no government ever voluntarily reduces itself in size, government programs once launched never go out of existence. A government agency is the nearest thing to eternal life we’ll ever see on this earth.” (Speech, October 27, 1964)

“There seems to be an increasing awareness of something we Americans have known for some time: That the ten most dangerous words in the English language are, ‘Hi, I’m from the Government, and I’m here to help.’” (Remarks to the Future Farmers of America, July 28, 1988)

“Sometimes bureaucracy’s excesses are so great that we laugh at them. But they are costly laughs. Twenty-five years ago the Hoover Commission discovered that Washington files a million reports a year just reporting there is nothing to report.” (Speech, March 31, 1976)

“Our government has no power except that granted it by the people. It is time to check and reverse the growth of government, which shows signs of having grown beyond the consent of the governed. It is my intention to curb the size and influence of the federal establishment and to demand recognition of the distinction between the powers granted to the federal government and those reserved to the states or to the people.” (Inaugural Address, January 20, 1981)

“I’ve always thought that the common sense and wisdom of government were summed up in a sign that they used to have hanging on that gigantic Hoover Dam. It said, ‘Government property. Do not remove.’” (Remarks before the National Alliance of Business, September 14, 1987; from *The Wisdom and Humor of the Great Communicator*, p. 60)

“If you will forgive me, you know someone has likened government to a baby. It is an alimentary canal with an appetite at one end and no sense of responsibility at the other.” (Remarks before the Canadian Parliament, March 11, 1981; from *The Wisdom and Humor of the Great Communicator*, p. 66)

“Today there is an increasing number who can’t see a fat man standing beside a thin one without automatically coming to the conclusion the fat one got that way by taking advantage of the thin one. So they would seek the answer to all the problems of human need through government.” (Speech, October 27, 1964)

“From our forefathers to our modern-day immigrants, we’ve come from every corner of the earth, from every race and every ethnic background, and we’ve become a new breed in the world. We’re Americans and we have a rendezvous with destiny. We spread across this land,

building farms and towns and cities, and we did it without any federal land planning program or urban renewal.” (Speech, March 31, 1976)

## **G. The Reagan Economic Program**

“Reducing the growth of [government] spending, cutting marginal tax rates, providing relief from overregulation, and following a noninflationary and predictable monetary policy are interwoven measures which will ensure that we have addressed each of the severe dislocations which threaten our economic future.” (Remarks, April 28, 1981)

“One of the best signs that our economic program is working is that they don’t call it Reaganomics anymore.” (*The Uncommon Wisdom of Ronald Reagan*, p. 58)

“In eight short years, we have reversed a 50-year trend of turning to the government for solutions. We have relearned what our Founding Fathers knew long ago—it is the people, not the government, who provide the vitality and creativity that make a great nation. Just as the first American Revolution, which began with the shot heard ’round the world, inspired people everywhere who dreamed of freedom, so has this second American revolution inspired changes throughout the world. The message we brought to Washington—reduce government, reduce regulation, restore incentives—has been heard around the world.” (*Economic Report of the President*, 1989)

“Common sense told us that when you put a big tax on something, the people will produce less of it. So, we cut the people’s tax rates, and the people produced more than ever before.” (Address to the Nation, January 11, 1989)

## **H. The Soviet Union**

“It is the Soviet Union that runs against the tide of history....[It is] the march of freedom and democracy which will leave Marxism-Leninism on the ash heap of history as it has left other tyrannies which stifle the freedom and muzzle the self-expression of the people.” (*The Uncommon Wisdom of Ronald Reagan*, p. 66)

“There is one sign the Soviets can make that would be unmistakable, that would advance dramatically the cause of freedom and peace. Secretary General Gorbachev, if you seek peace, if you seek prosperity for the Soviet Union and Eastern Europe, if you seek liberalization: Come here to this gate! Mr. Gorbachev, open this gate! Mr. Gorbachev, tear down this wall!” (Remarks at the Brandenburg Gate, West Berlin, June 12, 1987)

“Let us be aware that while they [the Soviets] preach the supremacy of the state, declare its omnipotence over individual man, and predict its eventual domination of all peoples of the earth—they are the focus of evil in the modern world.” (Remarks to the National Association of Evangelicals, March 8, 1983)

## **I. Communism / Socialism / Fascism**

“You know, there are only two places where communism works: in heaven where they don’t need it, and in hell, where they’ve already got it.” (*The Uncommon Wisdom of Ronald Reagan*, p. 65)

“I believe that Communism is another sad, bizarre chapter in human history whose last pages even now are being written.” (Remarks to the National Association of Evangelicals, March 8, 1983)

“It is time we realize that socialism can come without overt seizure of property or nationalization of private business. It matters little that you hold the title to your property or business if government can dictate policy and procedure and holds life and death power over your business.” (Speech, Oct. 27, 1964)

“During my lifetime, I have seen the rise of fascism and communism. Both philosophies glorify the arbitrary power of the state. These ideologies held, at first, a certain fascination for some intellectuals. But both theories fail. Both deny those God-given liberties that are the inalienable right of each person on this planet; indeed, they deny the existence of God. Because of this fundamental flaw, fascism has already been destroyed, and the bankruptcy of communism has been laid bare for all to see—a system that is efficient in producing machines of war but cannot feed its people.” (Remarks to Chinese community leaders in Beijing, China, April 27, 1984)

## Notes

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  - <sup>2</sup> Sandra Sugawara and Ariana Eunjung Cha, "Nasdaq Swoons After Plea; Point Drop is 2nd Biggest," *Washington Post*, March 15, 2000, p. E1.
  - <sup>3</sup> See AnnaLee Saxenian, *Regional Advantage: Culture and Competition in Silicon Valley and Route 128* (Cambridge, Massachusetts: Harvard University Press, 1994), pp. 48-9, 143.
  - <sup>4</sup> James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth," Joint Economic Committee report, April 1998.
  - <sup>5</sup> Jack Kemp in "Plugging in the Supply Side: A Twenty Year Retrospective," testimony to the Joint Economic Committee, March 9, 2000.
  - <sup>6</sup> Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here* (New York: W.W. Norton, 1999), p. 54.
  - <sup>7</sup> Michael J. Graetz, *The U.S. Income Tax*, p. 54.
  - <sup>8</sup> Michael J. Graetz, *The U.S. Income Tax*, p. 55.
  - <sup>9</sup> Robert L. Bradley, "What Now For U.S. Energy Policy? A Free Market Perspective," *Cato Policy Analysis*, Cato Institute, January 1991.
  - <sup>10</sup> See Alan Reynolds, "Monetary Policy by Trial and Error," in *The Supply-Side Revolution: 20 Years Later*, Staff report, Office of the Chairman, Joint Economic Committee, March 2000.
  - <sup>11</sup> See C-Span "Book Notes" transcript with Robert Barley, May 17, 1992.
  - <sup>12</sup> Historical effective tax rates on capital gains are from Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide For the Perplexed* (Washington: Brookings Institution, 1999). For pension plan rules, see "The Economics of the Private Equity Market," Federal Reserve Board of Governors staff report, December 1995. See also Organization for Economic Co-operation and Development, *Fostering Entrepreneurship* (Paris: Organization for Economic Co-operation and Development, 1998), p.76.
  - <sup>13</sup> See also the comments of Jack Kemp in "Plugging in the Supply Side: A Twenty Year Retrospective," testimony to the Joint Economic Committee, March 9, 2000.
  - <sup>14</sup> Letters to Senator Robert Packwood, November and December 1994.
  - <sup>15</sup> Quoted by Jack Kemp in "Plugging in the Supply Side: A Twenty Year Retrospective," testimony to the Joint Economic Committee, March 9, 2000.
  - <sup>16</sup> Congressional Research Service, "Proposed and Actual Budget Totals for the Fiscal Years 1980 Through 1996," April 21, 1997.
  - <sup>17</sup> Clifford Winston, "U.S. Industry Adjustment to Economic Deregulation," *Journal of Economic Perspectives*, v. 12, no. 3, Summer 1998, p. 101, Table 3.
  - <sup>18</sup> Organization for Economic Co-operation and Development, *The OECD Review of Regulatory Reform in the United States*, preliminary edition, May 1999, p. 17.
  - <sup>19</sup> Murray Wiedenbaum, "Progress in Federal Regulatory Policy, 1980-2000," in *The Supply-Side Revolution: 20 Years Later*, Staff report, Office of the Chairman, Joint Economic Committee, March 2000.
  - <sup>20</sup> Statement by Ronald Reagan on Regulatory Reform, Youngstown, Ohio, October 8, 1980.
  - <sup>21</sup> Rogelio Garcia, "Federal Regulations and the *Federal Register*: Statistical Measurements, 1976-1998," Congressional Research Service report RL30183, May 19, 1999, p. 7, and Office of the Federal Register.
  - <sup>22</sup> Murray Wiedenbaum, "Progress in Federal Regulatory Policy, 1980-2000," p. 48.
  - <sup>23</sup> Data are from James Gwartney and Robert Lawson, *Economic Freedom of the World 1997* (Vancouver: Fraser Institute: 1997), pp. 260-4.
  - <sup>24</sup> Alan Greenspan, testimony to the House Committee on Banking and Financial Services, July 22, 1999.
  - <sup>25</sup> Sander Wenekers and Roy Thurik, "Linking Entrepreneurship to Economic Growth," *Small Business Economics*, v. 13, 1999.
  - <sup>26</sup> Organization for Economic Co-Operation and Development, *Fostering Entrepreneurship*, p. 17.
  - <sup>27</sup> Daniel Gross, ed., *Forbes Greatest Business Stories of All Time* (New York: John Wiley and Sons, 1996), p. 330.
  - <sup>28</sup> See Amar Bhidé, *The Origin and Evolution of New Businesses* (New York: Oxford University Press, 2000), pp. 161, 163.