Reflections

My Time in the Reagan Administration

Paul Craig Roberts

When I was an economics professor, I often wondered if what my faculty colleagues and I were teaching students about economic policy had any validity. I left Stanford University, went to Washington, D.C., and joined the congressional staff in order to experience how policy is made. In the House, I helped Rep. Jack Kemp introduce supply-side economics to his colleagues. I became chief economist of the House Budget Committee on the Republican side, and then staff associate for Senator Orrin Hatch on the Joint Economic Committee.

My success in explaining to Congress that there was an alternative to Keynesian demand management, which had no solution for stagflation, led to President Reagan appointing me assistant secretary of the Treasury for economic policy. Having learned how policy is made (and unmade), I now had the assignment to implement a new one.

The story of my experience is useful to economists. As one of my graduate professors, Ronald Coase, used to tell his class, "It would help economists to occasionally look outside the window of the box they keep themselves in."

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The conflict between merit and redistribution that is characteristic of the American political system and the influence of established explanations are not the only problems confronting a policymaker, especially if he is introducing a new approach. As Niccolò Machiavelli wrote in *The Prince*, "There is nothing more difficult, more perilous or more uncertain of success than to take the lead in introducing a new order of things."

Intra-party Power Struggles, Not Economics, Are the Main Influence on Policy

One of the many problems a policymaker faces is that policies affect different interest groups in different ways. Some benefit, some don't, and I don't mean just in a material or economic way. Most of the things that influence economic policy have nothing to do with economics. They have to do with power. The party establishments that control the parties intend to stay in control. The organized interest groups that control the party establishments intend to continue in control.

Few Americans understand that the main political fight is not between the two parties but within the administration of the party in power. Within the parties the fight is over who controls the party. When the fight is between the establishment and a populist rival like Ronald Reagan or Donald Trump, it can get very nasty.

During the first year of the Reagan administration, much of the battle was between President Reagan and his Treasury allies (primarily me and Secretary Don Regan) on one side and Reagan's chief of staff, Jim Baker, chairman of the Council of Economic Advisers, Murray Weidenbaum, and Office of Management and Budget (OMB) director David Stockman on the other.

The fight within the Reagan administration had its origin in Reagan taking the Republican nomination for president away from the establishment's candidate, George H. W. Bush, former CIA director. Reagan was considered an outsider, and he was "dangerous" because the Republican establishment could lose its grip on the party to a populist whose basis was in the people and not in the organized interest groups.

Reagan was advised that he must take the defeated George H. W. Bush Republican establishment into his administration or suffer the fate of Barry Goldwater, who rejected Nelson Rockefeller after he defeated him in the Republican presidential nomination. Consequently, the Republican establishment helped the Democrats defeat Goldwater, the Republican populist candidate.

Nancy Reagan judged by appearances, and Bush's man, Jim Baker, a polished dresser, presented to Nancy a better image than Reagan's laidback California crew to be standing by her husband. Baker was appointed chief of staff. So, from the start Reagan and his supporters in the administration were handicapped by an establishment operative being chief of staff of the Reagan Revolution.

Only Reagan had offered a solution to the problem of "stagflation." It was called supply-side economics. Lacking a solution to offer during the campaign for the nomination, Bush termed Reagan's policy "voodoo economics." This, of course, played into the hands of the Democrat opposition and the liberal media determined to undermine President Reagan as a Grade B movie actor who believed in fairy tales about tax cuts paying for themselves.

Supply-Side Economics and Its Foes

The aspersion Bush cast on Reagan's policy had some traction in Republican ranks because of Republicans' traditional fear of budget deficits. Republicans such as Bob Dole and George H. W. Bush believed that budget deficits resulting from reduction in taxes would stimulate consumer spending, raise inflation and interest rates, crowd out private investment, and worsen the stagflation that emerged from Keynesian demand management during the Carter administration. Traditional Republicans had been well indoctrinated by Keynesian economists—whom, paradoxically, the Republicans opposed—that fiscal policy such as reductions in tax rates only affected the demand side of the economy. They believed that a tax rate reduction could only add to inflationary pressures by adding to consumer demand.

Many on Wall Street saw it the same way as Federal Reserve chairman Paul Volcker. The two main Wall Street economists—Dr. Doom and Dr. Gloom (Henry Kaufman and Albert M. Wojnilower)—stayed busy at work creating hysteria over the "coming Reagan deficits."

Volcker was also obsessed by the belief that the deficits resulting from the tax rate reduction would fuel the already high inflation. Volcker's concern was apparent in Treasury's meetings with him. The Treasury found Volcker immune to understanding the administration's assault on stagflation by shifting the aggregate supply schedule instead of the aggregate demand schedule. The Treasury asked Volcker to gradually reduce the growth rate of money as the tax rate reductions, delayed at Stockman and Weidenbaum's insistence, came into effect.

Having attended Volcker's meeting with his outside advisers, I advised Secretary Regan that Volcker, fearful of being blamed for the higher inflation he believed the tax rate reduction would cause, would throw on the monetary brakes and into recession we would go before the tax rate reductions would go into effect. As OMB director, David Stockman was relying on inflation to offset the effect on tax revenues of the tax rate reduction (the tax system was not indexed at the time of Stockman's forecasts) and thus balance the budget; the deficits implicit in Stockman's inflation assumption and in Volcker's monetary policy would be blamed on Reagan's supply-side policy, which economists considered a threat to their investment in Keynesian macroeconomics. Ears would be closed to the Treasury's explanation. The Treasury, lacking a dynamic revenue model, used the static revenue forecast that a

dollar of tax cut would lose a dollar of revenue and, therefore, spelled out the deficits. Stockman hid the deficits with his high inflation forecast. Volcker then collapsed the money supply, and the drop in nominal GNP exposed Stockman's deficits. A dishonest liberal media blamed the deficits on a mythical Treasury claim, a claim which it never made, that the tax cuts would pay for themselves.

Art Laffer and Jude Wanniski talked at times of tax cuts paying for themselves by expanding the revenue base. Walter Heller made the same point in behalf of the Kennedy tax rate reductions. In testimony before the Joint Economic Committee of Congress on February 7, 1977, Heller, chairman of the Council of Economic Advisers in the Kennedy administration, said: "Did it [the Kennedy tax rate reduction] pay for itself in increased revenues? I think the evidence is very strong that it did." Economists with a redistributive agenda, hostile media, and politicians attributed statements made by Laffer and Wanniski to the Treasury and to Reagan. Laffer and Wanniski were trying to calm Republican fear of budget deficits by pointing out that incentives can improve the tax base. The Laffer Curve does not say tax cuts pay for themselves. It merely illustrates that there are two tax rates that will produce the same revenues: a high tax rate on a small base and a low tax rate on a large base.

Walter Heller, who as chairman of the Council of Economic Advisers had championed President Kennedy's large reduction in tax rates, said that Reagan's similar tax rate reduction would inject too much inflationary purchasing power into the economy and asked, "How can the economy absorb that big an expansionary punch without aggravating our already intolerable inflation?" (*Wall Street Journal*, February 10, 1981). He didn't ask this question when he was championing the Kennedy tax rate reduction.

Everyone, except Reagan, the Treasury, and the *Wall Street Journal* editorial page, was still operating inside the Keynesian box. None had bothered, Fed chairman Paul Volcker least of all, to listen to the explanation that reductions in the marginal rate of taxation shifted the aggregate supply schedule and resulted in more production for the same money supply. The way to beat stagflation was to increase output relative to money, and inflation would decline. It is always difficult to introduce a new way of thinking. People have a vested interest in existing dogma because that is where their human capital is invested.

Another way of looking at the policy issue is that supply-side economics differed from the interest rate theory of the cost of capital. We were able to show that taxation substantially affects the cost of capital, whereas the cost of capital is inelastic with respect to changes in interest rates (Roberts, Robbins, and Robbins 1986). I have often wondered if economists missed the effect of taxation on the cost of capital because capital theory developed prior to the income tax.

Noting the rate at which liberal media was building opposition to Reagan's supply-side policy, budget director David Stockman concluded that Reagan would not succeed and moved into the Republican establishment balanced-budget camp,

which had no solution to stagflation. Jim Baker thought that a small tax rate reduction—5 percent—would be sufficient for the administration to declare a victory, while not being large enough to add significantly to the budget deficit, inflation, and interest rates. Baker perceived the opportunity to use the media to portray the Bush people as modifying Reagan, which would position them for taking credit for Reagan's successes and solidify the establishment's hold on the Republican Party, thereby keeping Rep. Jack Kemp at bay.

Losing Some Battles but Winning the War

The problem was Reagan didn't go for it, and neither did I. Without retelling the story in my book (Roberts 1984), Jude Wanniski summed up 1981 in his *Polyconomics* newsletter: "If there is anyone who deserves a supply-side medal with oak-leaf cluster it is Craig Roberts." I lost some skirmishes, Wanniski said, but I won the war. And I did get the medal, in fact two of them—the U.S. Treasury's silver medal for "outstanding contributions to the formulation of U.S. economic policy" and the French Legion of Honor for "the restoration of economic science and policy after a half century of state interventionism."

By August 1981, Reagan's tax bill was passed into law. With my job done, there was nothing left for me to do in the Treasury. Normally, when a president signs a bill, those responsible for its successful passage are invited to a White House signing ceremony and given one of the pens used to sign the bill into law. As his way of letting me know that I wasn't appreciated, Jim Baker or his deputy Richard Darman "forgot" to invite me to the signing ceremony. Reagan noticed and sent me the lovely letter that is displayed on the "About" page of my website (Roberts n.d.). The letter, of course, is worth more than a signing pen, and I thanked Jim Baker for it.

There was talk of shifting me to the Federal Reserve Board. Reagan confidant Justin Dart, Rep. Jack Kemp, Chase Manhattan Bank chairman and CEO George Champion, and other influential confidants of Reagan's were behind it. It would have caused Volcker a heart attack. But Don Regan and I saw that it wasn't yet time for me to go. Jim Baker and David Stockman were already at work controlling the narrative placed in the media that Reagan would repudiate his "excessive" tax rate reduction in his January 1982 State of the Union message. This, of course, ensured that no work or investment decisions would be made on the basis of a tax reduction whose life might be short-lived. Despite media reports that the tax reduction would be repealed, Volcker was nevertheless at work strangling the money supply.

Stockman began secret interviews with a left-wing journalist, William Greider, aimed at discrediting Reagan's economic policy. A victory was being turned into a defeat. Jim Baker argued that even a small tax reduction could be successfully presented as a Reagan victory. For Baker the issue was political perception, not fixing the economy.

The threat to Reagan's economic policy was serious, because his other agenda—an end to the Cold War—was based on the success of his supply-side policy. The George H. W. Bush Republican establishment had Reagan's presidency set up to go up in flames.

Whereas I had managed to keep the percentage reduction in marginal tax rates from being significantly molested, I had been unable to block Stockman's insistence that the tax rate reduction be phased in over three years, with the first reduction being limited to 2.5 percent, which was cancelled by the high rate of inflation, as the income tax was not indexed for inflation at that time. Phased in over three years, the tax reduction would be cancelled by the inflation rate. The tax rate reduction needed to hit all at once to have its impact. But Stockman and Jim Baker had Senate Republicans and Republican business leaders all in a huff about deficits. They wanted to raise taxes instead of lowering them. For Republicans, the solution to every economic problem was to balance the budget. It was this mindlessness with which I was at war.

Stockman's argument was, of course, the budget deficit. Phasing in the tax rate reduction would produce a smaller deficit. Additionally, inflation by raising nominal incomes would raise nominal GDP and produce more tax revenues to cover the deficit. Stockman was relying on inflation to balance the budget by pushing taxpayers into higher tax brackets. This was not the president's policy, as I pointed out to Stockman.

I told Stockman that he was hiding deficits behind his high inflation projections, but that inflation was going to collapse either as a result of the supply-side policy if we were able to secure the Fed's cooperation, or from the Fed in fear of our policy slamming on the brakes and bringing on recession, which the Fed did. Volcker's recession collapsed GDP and tax revenues and created budget deficits that were promptly blamed on the tax cut, which, being delayed, had yet to be implemented. The "Reagan deficits" were the Volcker deficits and the Stockman deficits covered up by Stockman's high projected inflation rates. Over the next years, the inflation rate collapsed, instead of hitting all-time highs as Wall Street and academic economists had predicted.

It is a myth that the Treasury said the tax cuts would pay for themselves. The Treasury's official position, based on its traditional static revenue model, was that every dollar of tax reduction would lose a dollar of tax revenue. But the initial deficits would fade with the expansion that followed, unless spending was left out of control. We kept reminding people that the agenda was to cure stagflation, not to balance the budget. The tax system had to be used to increase the quantity supplied at every price by increasing the cost of leisure in terms of forgone current income and increasing the cost of current consumption in terms of forgone future income.

During the autumn of 1981, immediately following the passage of the tax rate reductions, the battle raged inside the administration to whittle down or even totally repeal the supply-side reduction in marginal tax rates. The George H. W. Bush part of the administration had turned against the Reagan administration's victory.

It was the Treasury against Stockman at OMB, the White House chief of staff, the vice president, and the Council of Economic Advisers. As neither side would yield, three times the decision was taken to the White House. Each time Ed Meese and President Reagan's men sided with the Treasury. As soon as the presidential delegation left the room, Jim Baker would ask Don Regan, "Don, can't the Treasury make a better case?" And it would start all over again. After the third time, Regan asked me why Reagan didn't fire those who didn't hear his decisions. My answer was that Reagan was very non-confrontational and was relying on the Treasury. I think it was December when Regan told me he had had enough and was going to Florida. "It's in your hands."

Triumph and Departure after Reagan's 1982 State of the Union Address

The morning of Reagan's State of the Union address in January 1982, the lead article on the *Wall Street Journal*'s front page, a plant by Baker or Stockman, said that Reagan was going to back away from his irresponsible tax cut in his State of the Union speech.

Roger Mudd, the anchor for NBC News in those days, called me. "Craig," he said, "it looks like you are going to be repudiated tonight and the supply-side policy cast aside." I had just finished reading Reagan's State of the Union address, as the speechwriters had sent it over for my approval. I advised Roger not to take that line because Reagan was not backing off his policy. Roger laughed. Convinced that supply-side economics and I were done for, he offered to set me up in a room in the Capitol with a television so I could watch my repudiation in Reagan's State of the Union speech, and he would come in immediately after Reagan's address and we would go live on national TV as NBC's lead interview on the president's speech. He was surprised when I accepted.

In his State of the Union address Reagan delivered a stinging rebuff to his OMB director and chief of staff. Strongly reaffirming his commitment to his economic program, Reagan declared: "The doubters would have us turn back the clock with tax increases that would offset the personal tax-rate reductions already passed by this Congress. Raise present taxes to cut future deficits, they tell us. Well, I don't believe we should buy their argument" (Reagan 1982).

Having heard the opposite of what he expected, Mudd was shaken. Immediately we went live: "Craig, the president has just repudiated the advisers who tried to get him to raise taxes. They have egg all over their faces! What can they do?" I replied, "They can wipe the egg off their faces and get back on the president's team." Within seconds of my statement, my wife got a furious call from a Stockman aide whose voice she recognized: "We are going to get Craig and all his friends." Being a British lady, she was upset at the barbarity of the American government in Washington. I had served the president, which was my duty, not the establishment, and the establishment was going to "get me."

At the White House press conference the next morning, the first question Larry Speakes had to answer was, “Is Jim Baker still employed today? . . . He led the losing fight, and the general who gets beaten usually gets thrown out.”

Reporters and columnists began telling the story of how senior aides had worked to undermine congressional and business support for the president’s program. In a front-page story in the *Wall Street Journal* on February 2, 1982, reporters Rich Jaroslovsky, Ken Bacon, and Robert Merry told how Baker and Stockman operated against the president by building “momentum with leaks and pressure.”

I knew that Reagan could not throw out his vice president’s right-hand man, who had done so much to undermine the president of the United States, and that Reagan was stuck with Baker until Reagan’s second term, when Don Regan would take over as chief of staff. I knew that Baker, Stockman, Darman, and Larry Kudlow would use their friends in the media to destroy my reputation. I had done my job. Harvard University Press wanted the story. A prestigious chair was created for me, and I had no intention of spending years in internal administration fights. I explained the situation to Secretary Regan and President Reagan, and they agreed to keep my departure a secret so that the media could not make it look like I was driven out of the administration. Reagan said he would ensure that I escaped alive. He said he had further need for me in the future. I left and eased into the new William E. Simon Chair in Political Economy, Center for Strategic and International Studies, Georgetown University. Later Reagan appointed me to a secret presidential committee to assess the CIA’s opposition to Reagan’s plan to end the Cold War. This is another story, one that brought me up against the CIA.

Thwarting Continued Assaults on Reagan’s Policies from within the Party

My second victory over the establishment was as short-lived as my first victory. I was no longer in the Treasury to beat back the third assault from within the Reagan administration on Reagan’s supply-side policy. The assault was not coming from the Democrats. It was coming from the Republican establishment.

Determined not to be defeated in their agenda to “moderate” Reagan, by April 1982 Baker and Stockman were marching Reagan into a tax increase by lying to him that it was a tax reform, not a tax increase. They left the reductions in the personal income tax rates alone and focused on the business tax cut added to the Kemp-Roth bill by Treasury undersecretary Norman Ture. The business tax cuts consisted of accelerated depreciation.

The U.S. tax code specifies the years over which various kinds of business investments can be depreciated. Some of the schedules were very long, and inflation had eroded their real values. Something needed to be done to shorten the write-off periods. It is possible that too much was done to improve the situation for business, and that the pendulum had gone too far in the other direction.

Nevertheless, this was a "tax reform" Reagan could accept as it left his personal tax rate reductions alone.

Cleverly, Stockman and Baker tied Reagan conservatives' demand for spending cuts to the tax increase. They told Reagan the tax increase was a necessary part of the deal for the Democrats to accept spending cuts. The taxes rose and so did spending.

Stockman was not content to mislead President Reagan only about taxes. He also misled Reagan about spending bills in order to discredit Reagan with Republican senators and humiliate him with overridden vetos. Stockman chose a spending bill that funded popular programs such as jobs for the elderly to help them make ends meet, which was funded $2 billion less than Reagan had requested. Stockman told Reagan that the appropriation was a "budget-buster" in order to get Reagan to veto the bill. Senate Appropriations Committee chairman Mark Hatfield said, "By no responsible account can this be called a budget-buster." Many saw that Reagan was being manipulated by his chief of staff and budget director. Senator Mark Andrews declared, "Frankly I'm getting sick and tired of David Stockman and his mirror acts. . . . He's not serving the nation well, he's not serving the president well, he's not serving his party well" (Dewar 1982).

Even Democrat Speaker of the House Tip O'Neill called on Stockman to resign for failure to keep the president correctly informed about the spending bills. Jim Baker had to be aware of Stockman's perfidy, but he protected Stockman, who remained in office doing as much damage as he could to the Reagan Revolution. It was like what Trump's appointees did to him during his first term.

Rowland Evans and Robert Novak, columnists who closely watched the Washington scene, saw the tax increase as Baker's attempt to portray supply-side economics as a failure and thus to remove Jack Kemp as a contender for the presidential succession. Others concluded that Reagan was not sufficiently involved to take control of his policy. The liberal-left columnists had a field day.

The administration of Reagan's successor, President George H. W. Bush, again raised taxes, and their target this time was the personal income tax rates. As Reagan and I were absent the scene, they had a free hand. Nevertheless, although they raised the personal tax rates, they left them significantly below the rates that prevailed prior to the supply-side reduction in Reagan's personal tax rate reductions. Even today, the tax rates are lower than they were prior to the Reagan tax rate reduction.

The real value of the Reagan tax cut was due to Senator William Armstrong's amendment and to my success in bringing the administration on board with Senator Armstrong's amendment, which had passed the Senate, to index the personal income tax for inflation. Over time even a low rate of inflation would inflate all incomes into the top bracket. In the House, the Democrats had come up with their own supply-side tax cut. White House speechwriters were looking for a way to differentiate Reagan's tax cut bill from the Democrat one that cut rates more in the first two years. My principal deputy, Steve Entin, produced a graphic showing that indexing

provided the dramatic comparison that the White House was seeking. Reagan was delighted. He used it in his television address just prior to the vote. Reagan quipped that the Democrat's tax cut is larger "if you're only planning to live two more years." Without indexing, inflation eroded the benefit of the Democrat tax cut bill.

I can take satisfaction that my efforts, together with those of my Treasury colleagues, the White House speechwriters, and White House economist Martin Anderson, forty-four years ago in behalf of a supply-side economic policy have had a positive impact for four decades. Subsequent policymakers who offshored jobs, destroyed supply chains and the tax base of manufacturing and industrial states, created monopolies, financialized the economy, and weaponized the dollar, thus setting in motion the loss of the dollar's role as reserve currency, have a great deal to answer for. For me, I can point to an enduring success. If the top marginal tax rates were still 70 percent on investment income and 50 percent on earned income, we would hardly have an economy at all.

The Permanence of the Supply-Side Revolution

There was no significant difference between the Kennedy tax cut in 1964 and the Reagan tax cut in 1981. The only difference is in the economic interpretation of tax rate reductions.

In the Keynesian view, a tax rate reduction stimulates consumer demand by leaving more money in the pockets of consumers to spend. The result is a rise in aggregate demand that leads to an increase in employment and investment in order to meet the higher demand, but it can also result instead in inflation with prices instead of output and employment rising if high tax rates discourage increases in output.

In the supply-side view, a tax rate reduction changes two important relative prices that cause an increase in aggregate supply. One of the prices is the price of leisure in terms of forgone current income. Lowering tax rates raises the cost of leisure in terms of the income you give up by, for example, taking Friday afternoons off. If you are in a 50 percent marginal tax rate, you only get to keep 50 cents of each additional dollar you earn. If the tax rate is cut to 30 percent, you get to keep 70 cents of each additional dollar you earn. Thus a lower tax rate makes leisure more expensive and encourages more labor supply.

The other price is the price of current consumption in terms of forgone future income. If you deplete your income in consumption instead of saving and investing, you forgo higher future income from investments not made. If the tax rate on investment income is 70 percent, each dollar of investment income only brings you 30 cents. If the tax rate is lowered to 50 percent, the reward to saving and investing rises to 50 cents for every dollar earned. Therefore, a reduction in the tax rate on investment income makes current consumption more expensive in terms of forgone future income and encourages more investment.

Whereas Keynesian demand-side economists believe fiscal policy such as changes in tax rates only affects aggregate demand, supply-side economists point out that some fiscal policies, such as changes in tax rates, directly affect aggregate supply. The supply-side revolution resulted from the realization after decades of demand management that fiscal policy directly affects aggregate supply. The Keynesian policy of stimulating consumer demand with Federal Reserve money creation while restraining output with higher tax rates resulted in stagflation. The supply-side solution was to remove the disincentives to work and invest caused by high tax rates.

Paul Samuelson, the top-of-the-line Keynesian economist in those days, agreed with the supply-side correction of fiscal policy. But he wondered how powerful the supply-side effect would be. Was it strong enough to have a significant effect? Paul Evans, a Stanford University economist, had already answered Samuelson's question. I asked the Treasury staff to re-estimate Evans's work on the impact of the Kennedy tax rate reduction on consumption and saving. Had the Kennedy tax cut caused consumption to rise or saving to rise? The empirical record was clear. Consumers spent a smaller percentage of their lower-taxed incomes. There was a marked increase in the real volume of personal saving following the Kennedy tax cut, and the saving rate, which had been declining during the early 1960s, rose sharply. It remained high for a decade, until rising marginal tax rates from a non-indexed tax system pushed it down. It was clear that the Kennedy tax rate reduction worked because of its supply-side effects.

The two tax rate reductions in the latter half of the twentieth century kept the American economy alive. The Kennedy tax rate reduction in 1964 slowed the erosion of America's economic potential, and the Reagan tax rate reduction in 1981, married with the indexation of the tax rates, boosted the economy's potential. A return to sound economic policies that focus on boosting productivity in the long run would help return the country to the strong growth path it enjoyed during the Reagan era.

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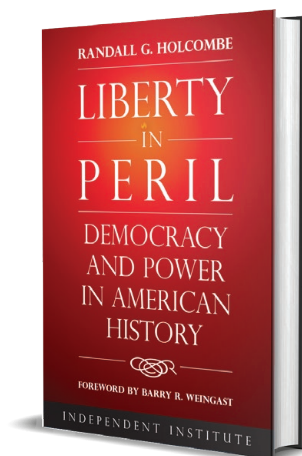

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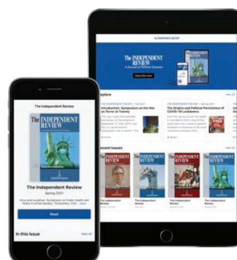

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