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ISSUES & INSIGHTS

PERSPECTIVE

Changed The World: Credit Reaganomics For Wide Prosperity

BY JOHN RUTLEDGE

With the passing of that great and graceful man who had such an enormous impact on America, I thought this would be a good time to remind everyone what the Reagan economic plan was all about. The people who tear Reaganomics apart on the Sunday talk shows were not there when it was created. Their version is a straw man — a gross caricature of the real thing.

Two weeks after Ronald Reagan defeated Jimmy Carter for president in November 1980, I got a phone call: "Would you be willing to come to Washington and help write President Reagan's economic plan?"

I was a 32-year-old economist with a chance to change the world.

"Are you kidding?" I said, "I'll be there tomorrow morning."

Choked By Stagflation

That night I boarded a red-eye flight to start the most wonderful adventure of my life. Over the next few months, Larry Kudlow and I, with my colleagues at the Claremont Economics Institute, produced the plan people now call Reaganomics.

Young people today need to understand that, when Reagan was elected, the American people were deeply discouraged. Inflation was 15%, the top federal income tax rate was 70%, the top tax rate on investment income was 91%, interest rates were 21%, the Dow was below 1000, the Soviet Union was a menace, the Berlin Wall divided families, and the Khomeini government in Iran was holding Americans hostage in Tehran.

Back then they called it stagflation. The centerpiece of every contract was the cost-of-living-adjustment clause, an automatic consumer-price index escalator for prices and wages. More than half of people's wealth was tied up in tax shelters and inflation hedges, which had driven gold, silver, oil and commodity prices up and virtually destroyed the stock and bond markets. There was no capital available to start and grow businesses and create jobs.

Today, inflation is below 2%, the top income tax rate has been cut in half, interest rates are below 2%, the stock market is above 10,400, the Berlin Wall is gone and our children learn about the Soviet Union in history class. The hostages were released on the very day Reagan was sworn in.

These changes are the legacy of the Reagan presidency. They did not happen by accident.

All this worked because President Reagan understood that to make things better, we have to work. As the Gipper reminded us every time he spoke, the real heroes in America are the workers — the factory workers, the miners, the waitresses, the cabbies, the teachers and the homemakers who go to work every day to build a better life for their families.

A Simple Plan

Reagan believed that work, not government, was the answer to our problems. His genius was communicating to people that he respected them, that he understood their problems and that he believed in them.

Thing was, he really meant it. The Gipper was the real deal.

The underlying principle behind the Reagan economic plan is very simple. People are capable of managing their own lives. People respond to incentives. Government policies influence those incentives. So let's get the incentives right.

Our work was based on the idea that people respond to two different kinds of incentives.

The first are the incentives that affect what people do. Changes in tax rates change people's after-tax income, which affects their choices about how much of their time to use for work and how much to reserve for leisure or work at home.

Changes in after-tax interest rates help people decide how much of their income to spend and how much to put away to educate their children or save for retirement. These factors directly affect the GDP accounts, our measure of how much we work and how much we produce.

The second type of incentives affect what people own, how they manage their assets. This is extremely important because our asset base (more that $120 trillion dollars today) is more that 10 times as large as our GDP (just over $11 trillion this year.) Changes in inflation and tax rates directly impact relative after-tax returns, which affects people's choices about how to divide their wealth among different types of assets, such as stocks, bonds or real estate.

These factors affect our balance sheet, which measures what we own. They show up as changes in asset prices, capital formation and growth.

The Reagan economic plan had four legs, like a chair.

- Reduce tax rates to encourage work, saving and investment, and to remove the penalty to own stocks and bonds.
- Reduce government spending to shift resources from the government to more productive, better incentivized, private hands. We actually wore buttons in the White House then that said: "The Private Sector Does It Better."
- Deregulate industry to improve productivity, increase returns on capital and encourage investment.
- Reduce inflation to refocus people's energies away from inflation hedging, back to economic fundamentals and remove the artificial subsidy to own sterile hard assets.

The shrieking from opponents began before the ink was dry. On Wall Street, Dr. Doom and Mr. Gloom argued about whether the initial budget deficits from the tax cuts and inflation cuts would drive interest rates to 30% or to 40%.

Rates Fell

They were wrong, of course. People were smart enough to start moving their money from the Krugerrands and collectibles that made sense in the 1970s to the stock and bond markets, where they provided capital for new businesses and new jobs.

Interest rates began the fall that would drive the stock market and the American economy the next two decades. Commodity prices collapsed, which forced American companies to restructure and become more competitive, and deprived the Soviets of revenues from oil, gas, gold and commodities they used to fund their military, which ultimately drove them into bankruptcy and dissolution.

In the end, Reagan achieved three of the four goals of his plan. Taxes, inflation and regulations were all drastically reduced. But spending cuts ran into a congressional stone wall.

And weaning America from its addiction to tax shelters and inflation hedges was not without cost. The 1980s' restructuring pains were real.

But the gains were massive and lasting. Today, instead of keeping more than half their net worth in sterile tax and inflation shelters, people have invested more than 70% of their money in the stock and bond markets to finance the growth of our companies — a $24 trillion tidal wave of investor demand that has driven interest rates down to today's low levels and is financing the extraordinary growth we see in the world today.

So it is right that we take a minute to reflect on what things were like before the Gipper. We don't want to go there again.

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