

**RONALD REAGAN AND THE RISE OF LARGE DEFICITS:
WHAT REALLY HAPPENED IN 1981**

by

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In the battle over Ronald Reagan's legacy, the events of 1981 are prominent. Critics contend that the large deficits of the 1980s were Reagan's fault: the product of an irresponsible plan to cut taxes and increase defense founded upon economic assumptions that were obviously over optimistic. The critics are wrong. Because budget projections in early 1981 called for massive surpluses, it was possible, based upon the data then known, to cut taxes, increase defense, and still balance the budget. Regarding the economic forecast, the Reagan package of projections were, at most, only mildly more optimistic than other forecasts at the time. Neither Reagan nor other forecasters for an throughout 1981 that the country was on the verge of the worst recession since the Great Depression. This recession drastically reduced inflation, benefitting America, while producing the budget deficits that only recently have ended.

The battle for the legacy of Ronald Reagan continues. Many of his 1980s critics remain unrelenting. Although they attack on a broad front, Reagan's role in the creation of the large budget deficits of the 1980s is one of the most frequently cited faults of his presidency. Ronald Reagan promised tax cuts and a defense build up as part of a painless package to balance the budget, the critics charge, and look what happened.

Sidney Blumenthal, currently in the White House, is one of the most strident critics. At the beginning of the Clinton Administration, he used his New Yorker column to repeat the charge that the Reagan Administration manipulated the budget numbers, resulting in the deficit explosion.¹ Even generally sympathetic portraits of Reagan deplore his budget record. Thus, the 1998 Public Broadcasting Series "American Experience" credited Ronald Reagan for his role in the Cold War, but decried his budget and economic plans.

This paper challenges the conventional wisdom about the original Reagan plan. Neither the President nor his advisors ignored economic reality as it was then understood nor did they use unrealistic assumptions or economic theories. Section I discusses the original Reagan budget and economic forecast, made early in 1981. I then discuss the failure to change the economic plan during 1981 by focusing on the economic facts as known at the time of the famous parking lot conversation between David Stockman and Richard Darman on July 23, 1981. Next, the accuracy of the second Reagan economic and budget plan, released in early 1982, is considered. Section IV then considers the role of non-economic elements in contributing to the inaccurate deficit projections in the initial Reagan budgets. The final section contains concluding remarks.

I. The First Reagan Plan

To begin with, the Reagan proposal never assumed that tax cuts would increase revenues. Instead, the proposal followed the normal budgeting convention that reducing tax rates would decrease revenues below their projected levels.² Before the reader discards this paper in sheer disbelief, consider that under the policies in existence at the beginning of 1981, revenues were projected to increase rapidly. As we shall see in more detail below, so rapid were these

increases that massive budget surpluses, not deficits, were projected for the mid-1980s. Given these expected surpluses, taxes would be cut and the budget still be balanced.

Yet, this is not the end of the story. A knowledgeable critic might respond that the original Reagan program relied on a wildly optimistic economic forecast. Even if the Reagan numbers never directly assumed that tax cuts would increase revenues, the economic forecast produced this result indirectly. David Stockman's book, The Triumph of Politics, is oft-cited proof of this charge. As Stockman stated:

The budget numbers printed in February 1981 said you could have a big tax cut and a big defense buildup, and still have a balanced budget by 1984. That would be followed by a \$28 billion surplus by 1986. But it all depended upon Rosy Scenario.³

The infamy of the Reagan Administration's initial forecast has become so familiar that many refer to it as the Rosy Scenario, with, as did Stockman, the capital letters denoting its notoriety. In evaluating whether the original Reagan program was based on the economics of the free lunch, we must therefore evaluate this first forecast.

How do we measure whether the initial forecast was really rosy? The forecast has been condemned as rosy when compared with what actually happened. The Administration's deficit forecast for fiscal 1982, released in February 1981 with its proposed program, was \$45 billion, when the actual deficit was \$128 billion.⁴ Even though a large percentage of Reagan's proposals were eventually enacted,⁵ the deficit forecast was inaccurate largely because of the economic forecast. But hindsight is, as they say, 20-20. To understand the actual degree of optimism of the Reagan forecast, we must view the world as Stockman and his compatriots found it in 1981, not as it turned out to be months or years later. Thus, we must evaluate what those in the Reagan Administration knew at the crucial times when that Administration's tax and spending policies were created and implemented. To address this issue, let us compare the Reagan forecast with others made at the same time. Table 1 provides the Administration, Congressional Budget Office, and Blue Chip GNP growth and inflation forecast for calendar year 1981 and

1982, as they were made in early calendar year 1981.⁶ (In those days, forecasts were in GNP, not GDP.)

TABLE 1

Economic Forecasts for 1981 and 1982
(as made in early 1981)

<u>1981</u>			
	Real GNP	GNP Deflator	Nominal GNP
Reagan Administration (February 1981)	1.1	9.9	11.1
CBO (March 1981)	1.3	10.3	11.8
Blue Chip (March 1981)	1.3	9.9	11.3
Actual	1.9	9.4	11.6

<u>1982</u>			
	Real GNP	GNP Deflator	Nominal GNP
Reagan Administration (February 1984)	4.2	8.3	12.8
CBO (March 1981)	2.5	9.2	11.9
Blue Chip (March 1981)	3.7	8.6	12.6
Actual	-1.9	6.0	4.0

Sources: OMB, CBO, Blue Chip

do All numbers are year over year. Actuals are as recorded in the early 1980s and not reflect subsequent benchmark revisions of GNP.

Compared to what happened, the Administration was wildly inaccurate, projecting over four percent real growth in 1982 when the economy actually declined almost two percent. But CBO and Blue Chip both were also wildly inaccurate in their real growth projections. Relative to CBO and Blue Chip, Reagan was still overly optimistic. Although not trivial, the optimism, 1.7 percent greater growth than CBO, is not nearly as large as the actual mistake in each forecast. Nevertheless, if this information was all that we possessed, the Reagan Administration could be found guilty of some excessive optimism, even when measured against the yardstick of other contemporaneous forecasts.

But real GNP growth is not the whole story. The issue is whether the deficit forecast was rosy, with rosy measured by a comparison to the other forecasts. Deficits, of course, equal outlays minus governmental receipts. Starting with receipts, the driving force for their computation is nominal, not real, GNP.⁷ Table I reveals that the nominal GNP forecasts were closer than the real GNP forecasts, particularly when comparing the Administration and CBO. The nominal GNP forecasts were accurate for 1981, but none of these forecasts predicted the 1982 recession or the disinflation that accompanied it. In 1982, nominal GNP grew by only one-third (or less, depending on the forecast) of the predicted amounts.

What of the other half of the equation, outlays? Here, other economic assumptions are relevant. Projected unemployment rates, for example, determine the discrepancy between forecasted unemployment benefits and outlays for other programs sensitive to that rate and the actual levels. (Of course, unemployment rates themselves are highly correlated with growth forecasts.) Although the Administration's (7.2) and Blue Chip's (7.3) unemployment forecasts for 1982 were virtually identical, CBO's (7.9) was closer to the actual (9.7). Moreover, interest rate projections are important in determining the outlays for programs sensitive to those rates. For example, as the deficit increased, it had to be serviced. Reagan's projection of one 1982 interest rate, 8.9 for the three month Treasury Bill, was significantly lower than the actual, 10.7.⁸

Table 2 compares the three forecast's misestimates of the 1982 deficit. Budget technicians frequently divide the deficit misestimates into adjustments caused by three variables: inaccurate economic assumptions, policy changes proposed but not enacted, and technical

assumptions made in the original forecast that turned out to be inaccurate (e.g., the number of individuals who would qualify for any particular program or the number of bank failures requiring payment of deposit insurance). A word of caution is in order. The split between economic, policy, and technical is necessarily somewhat arbitrary, at least in practice. For example, interest rates affect the extent to which banks and S & L's fail. Yet mistakes in estimating the failure rate are classified as technical even if changes in interest rates influence the failure rate. Moreover, the order in which the estimates are made matters. Calculating errors from economic and policy changes first, and calling the residual "technical," as is the current practice, can produce somewhat different results from those derived when the order is changed. Thus, care must be taken when comparing the estimates of different individuals or organizations. What matters for our purpose, however, is the use of a consistent estimating method. Our primary interest is the relative comparison between the forecasts, not the precise reliability of the absolute numbers. To give some sense of the crudity of the methodology, and to avoid a false precision, the numbers are rounded to the nearest billion dollars.

The table shows that the Reagan projection of the 1982 deficit, made in early 1981, proved to be optimistic by \$70 billion because of its economic assumptions, with most of the error on the receipts side. This is a large mistake indeed, particularly given that the deficit was \$128 billion. Substituting CBO and Blue Chips' economic forecasts for that of the Reagan Administration yields large economic errors as well, although not as large as that of the Administration. All three forecasts were wildly inaccurate, primarily because of their failure to predict the recession and the accompanying disinflation. Thus, based on the knowledge available to the Reagan Administration at the time it released its forecast, it was, at most, mildly optimistic. The Reagan forecasters can be said to have worn rose-colored glasses only if the same hue was found on other forecasters as well.⁹

The disparity in real growth projections among the early 1981 forecasts grew for 1983 and 1984. The Administration's initial 1981 forecast, predicting real growth of 5 percent for 1983 and 4.5 percent for 1984, significantly exceeds that of Blue Chip, 3.7 and 3.0, and CBO, 2.7 and 3.0. Because the Administration projected the GNP deflator would fall to 6.0 by 1984

(compared to an actual 3.8), while CBO (8.1) and Blue Chip (8.2) projected much smaller declines, the three forecasts had nominal GNP projections much closer than the real growth numbers implied. Thus, if Table 2 were extended to include the mistakes of the out year forecasts, then the three forecasts would retain their relative relation in misestimating the deficit, although the size of the mistakes would grow. For example, CBO disagreed that the Reagan plan as enacted would produce a deficit of only \$22.9 billion in 1982 and budget balance in 1984. But CBO's published projections for those years - - deficits of \$55 billion for 1983 and \$50 billion for 1984 - - although more accurate, were still wildly inaccurate.

<p>TABLE 2</p> <p><u>Mistakes in 1982 Deficit Forecasts</u></p> <p><u>Due to Economic Assumptions</u></p> <p>(\$ in billions)</p>			
	Reagan Administration	CBO	Blue Chip
Receipts	48	52	43
Outlays	22	9	13
Total	70	61	56
Source:	OMB		

II. Stockman and Darman in the White House Parking Lot

Thus far, we have discussed forecasts made at the beginning of 1981.¹⁰ Although proposed in February, the Reagan reforms were not implemented until much later, with the crucial tax package passed in July. Surely, by then the participants in the budget drama of 1981 saw that large deficits would occur. This view is reenforced by David Stockman's description of his famous conversation with Richard Darman in the White House parking lot on July 23, 1981:

We paced around the parking lot some more.

"I don't know which is worse," Darman said, "winning now and fixing up the budget mess later, or losing now and facing a political mess immediately."

* * *

"Let's get at it," he urged. "We win it now, we fix it later. I can think of worse choices."¹¹

This passage does not show that Stockman and Darman knew of the massive deficits that would follow. What prompted their gloom was the increasing size of the 1981 tax bill and the Administration's failure to achieve all of the spending cuts it desired. As of July, there was no reliable evidence of the looming recession. Consider Table 3, presenting headlines from the Blue Chip monthly reports for March, 1981 through July, 1981. These headlines reveal that most economists remained optimistic. Although the Blue Chip forecasts for 1982 had decreased from 3.6 percent in January to 3.2 percent in July, this change provides no indication of the massive drop to come.

Viewed in this light, Stockman and Darman could not have known of "\$200 billion deficits as far as the eye can see," a phrase Stockman used much later. Instead, they were recognizing that they could not achieve budget balance, and that large deficits by the standards of 1981 would occur. In his book, Stockman himself discussed projecting in August, 1981, that the deficit would reach \$112 billion in 1986.¹² Although deficits of this size were shocking in 1981, if the deficit had stayed at this level through the mid 1980s, we would now regard it as a tremendous victory.

CBO's baseline budget projections, published in July 1981, provide additional indication

of the budget world's ignorance during the summer of 1981. Assuming that the Reagan policies were not adopted -- that is taxes and domestic spending would not be cut and defense spending would not be increased, CBO projected that there would be a budget surplus of \$18 billion in 1983, growing to a surplus of \$209 billion in 1986.¹³ As hard as it may be to believe in light of what actually happened, the new Administration in 1981 faced the reverse situation of the Clinton Administration in 1993. Rather than face projections of massive deficits if policies were not changed, the projections were for massive surpluses. These projections, not reliance on extreme economic assumptions, explain how the Reagan Administration could propose a tax cut and defense increase, yet avoid massive deficits.

TABLE 3

Blue Chip Headlines:

March - July 1981

March	"1981 Economic Consensus Inches Upward"
April	"1981 Full Year Consensus Forecast Continues to Pick-up Steam"
May	"1981 Consensus Forecast Tilts Up Again"
June	"The Recovery Continues"
July	"Economic Exuberance Envisioned For 1982"

III. The 1982 Plan

If the Reagan Administration did not understand the severity of the problem in the summer of 1981, cannot one claim that they surely understood soon thereafter? If so, then the criticism of the Reagan Administration is correct, at least as to the next round of deficit forecasts. When Administration forecasts are compared to CBO and Blue Chips, however, the charge is still inaccurate. Blue Chip continued to revise its 1982 economic forecast downward, but not until November did the consensus agree that a recession had started. Moreover, the belief was that the recession would be short and not particularly dramatic. This belief continued into calendar year 1982, when forecasts for 1983 were released. Table 4 repeats the numbers in

Table 1, this time using forecasts made in early calendar year 1982 for 1982 and 1983.

Thus, months after the Reagan "revolution," neither the Reagan Administration nor CBO nor a consensus of private forecasters understood the calamity that they were already in. Moreover, although Reagan's forecast is significantly more rosy on GNP growth, its prediction of the decline in the GNP deflator was more accurate than the other forecasts, although still wildly inaccurate. The Administration's projected nominal GNP was not significantly different from that of the other forecasts.

TABLE 4			
Economic Forecasts For 1982 and 1983			
(as made in early 1982)			
<u>1982</u>			
	<u>Real GNP</u>	<u>GNP Deflator</u>	<u>Nominal GNP</u>
Reagan (February 1982)	0.2	7.9	8.1
CBO (February 1982)	-0.1	7.5	7.5
Blue Chip (March 1982)	-0.3	7.5	7.2
Actual	-1.9	6.0	4.0
<u>1983</u>			
Reagan (February 1982)	5.2	6.0	11.5
CBO (February 1982)	4.4	7.3	11.9
Blue Chip (March 1982)	3.8	6.9	11.0
Actual	3.7	3.8	7.7

Table 5 repeats Table 2's analysis of deficit misestimates, this time for fiscal year 1983. For critics of the Reagan forecasts, this Table reveals a startling fact. In the midst of the worst recession since the Great Depression, the forecasters were, if anything, even more inaccurate than they had been the year before. Relative to CBO and Blue Chip, OMB's performance had

improved a bit, due mainly to its better projections of outlays compared to those of the year before.¹⁴ This is not to say that, by early 1982, budget officials did not recognize that they had serious problems. Indeed, by early 1982, they were projecting unprecedented deficits. The extent of those problems, however, and the serious disinflation that was their major source, were not understood even at this late date.

William Niskanen raises another criticism of the Reagan record. Although not a Rosy Scenario, he argues that the early forecasts had a major technical problem in that the real growth assumption was higher than that consistent with the assumed monetary policy.¹⁵ Even if true, we saw above that substitution of forecasts regarded as more credible, such as CBO or Blue Chip, produces most of the same deficit mis-estimate. Moreover, the early 1982 forecast (Table 4), which Niskanen does not analyze, also projected real growth higher than CBO and Blue Chip, with a lower GNP deflator. Yet, as Table 5 reveals, the non-Administration forecasts would have produced virtually identical deficit mis-estimates.

For the rest of the 1980s, the forecasts would improve. No economic assumptions after 1983 would approach the inaccuracy of those made in the first two Reagan years, whether by the Administration, CBO, or the Blue Chip consensus.¹⁶ But the damage had been done.

TABLE 5
Mistakes in 1983 Deficit Forecasts
Due to Economic Assumptions
(\$ in billions)

	<u>Administration</u>	<u>CBO</u>	<u>Blue Chip</u>
Receipts	66	65	67
Outlays	6	2	7
Total	72	67	74

Source: OMB

IV. Non-Economic Problems With the Reagan Projections

As discussed above in Section I, a deficit forecast can be inaccurate for reasons other than mistaken economic assumptions. Perhaps the Reagan budgets would have made matters even worse, for example by proposing larger defense increases or tax cuts than Congress enacted. Table 6 addresses this issue for the 1982 and 1983 Reagan budgets. It shows that the combined deficits underestimates were a whopping \$157 billion.¹⁷ The vast majority, 82 percent, result from the mistakes in economic assumptions discussed above. Had Congress fully enacted the policies proposed in the Reagan budgets, the deficits would have been higher, but only by three billion dollars. Largely because receipt reductions for 1982 was not as great as Reagan proposed due to a delay in the effective date of the tax cut, policy differences from the Reagan program did decrease the deficit for that year by \$15 billion. Reagan policies that would have reduced the deficit by \$12 billion were not enacted the next year, mostly proposals for lower domestic and entitlement spending. Thus, in the aggregate, the policies in the first two Reagan budgets did not significantly contribute to the mistaken forecasts.¹⁸

TABLE 6
Source of Deficit Misestimates in 1982 & 1983 Reagan Budgets
(\$ in billions)

Policy	-3
Economic	137
Technical	<u>33</u>
Total	167

Source: OMB

V. Concluding Thoughts

In discussing this paper with readers critical of its thesis, two comments have been raised. The first is that Stockman, the architect of Reaganomics, has himself renounced his work. Although true, this hardly ends discussion. Moreover, I agree with William Niskanen, who as a member of the Council of Economic Advisors was a colleague of Stockman's, that Stockman's book "understate[d] the effects of the Reagan economic program and Stockman's own contribution to that program."¹⁹ In any event, whether one accepts the view of this paper or the theories it rebuts, Stockman's main policy thesis remains intact and must stand or fall on arguments unrelated to this paper -- the Reagan years showed that spending cannot be seriously cut and thus massive tax increases were needed to eliminate the deficit.

The second comment is that forecasting turns in the economy is widely known to be difficult, and hence this paper presents nothing new. Of course, this comment is inconsistent with acceptance of Stockman's blame of Rosy Scenario, although some have raised both points. At the least, this paper is inconsistent with the popular view of what happened in 1981. Perhaps more important, even the academic literature lacks the comparison of the Administration and other early 1981 forecasts' deficit estimates found here as well as a detailed discussion of the failure to assess the economy accurately in the summer of 1981 and in early 1982.

Thus, despite the protestations of Sidney Blumenthal, PBS, and many others, the problem of large deficits was not created by malevolence or even overoptimism. A major source of the problem was a deep recession, the severity and even the existence of which were unforeseen. This view of the problem - - as a failure to understand the economy - - helps explain the fundamental political dilemma that arose: voters support neither large deficits nor the changes in spending and tax policy to eliminate, or significantly reduce, them. The voters and politicians did not favor creating large deficits but, once they arrived, a majority of both groups for years opposed steps that would eliminate them.

This explanation of the role of widespread ignorance in creating large deficits is not as exciting as explanations that seek to find villains to blame for our troubles. It is nowhere written, however, that the truth must be exciting.

¹ Sidney Blumenthal, "The Sorcerers Apprentices," *The New Yorker*, 29-34 (July 19, 1993).

² See Martin Anderson, Revolution: The Reagan Legacy, pps 152-57 (1989).

³ David Stockman, The Triumph of Politics: Why the Reagan Revolution Failed (New York: Harper and Row, 1986), p. 396.

⁴ Although the plan was first released in February, many of the details did not come until later. Moreover, the 1982 estimate and actual figures are not directly comparable, as the latter includes all off-budget entities. The 1982 deficit, excluding off-budget entities, was \$110.6 billion. OMB estimates that, adjusted to conform with the full budget totals, the original Reagan proposal produced a deficit of \$61.7 billion.

⁵ See Section IV below, discussing non-economic sources of misestimates in the Reagan deficit projections.

⁶ I follow the normal budgeting convention and present economic forecasts in calendar years and deficit forecasts in fiscal years. Blue Chip reflects a consensus of leading private forecasts. Eggert Economic Enterprises, Inc., "Blue Chip Economic Indicators."

⁷ Nominal GNP was particularly important before the personal income tax was indexed for inflation. Other aspects of the GNP forecast besides its size are relevant, including the distribution of income among various taxable sources and into taxable and nontaxable components.

⁸ One might ask why estimates of the GNP deflator were high while those of interest rates were low. The answer appears to lie in the fact that in the late 1970s inflation had caused a negative spread between interest rates and the GNP deflator, harming creditors. The credit markets, determined not to make that mistake again, widened the interest rate-GNP deflator spread more than many predicted.

⁹ CBO, The Economic and Budget Outlook: An Update, p. 37 (Sept. 1981) (the point estimates for CBO represent the mid point of estimates that CBO presented as ranges).

¹⁰ A considerable literature exists discussing the development of the budget in Reagan's first year, some of which considers the initial forecast. For example, White and Wildavsky note the unpredicted recession and compare the similar nominal GNP forecast in President Carter's last budget and President Reagan's first. Joseph White and Aaron Wildavsky, The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s, Russell Sage Foundation (Berkeley: University of California Press 1989), p. 341. Allen Schick explicitly rejects the charge that Reagan intentionally created deficits to limit future spending. Allen Schick, The Capacity to Budget, (Washington: The Urban Institute Press 1990), p. 137-38. Although both

books criticize the original Reagan forecast, neither present the detailed comparisons of various forecasts contained in this paper nor does either book consider the topic of the remainder of this paper - - the continual failure through early 1982 of forecasters, both within and without the government, to apprise the economy accurately. In Reaganomics (New York: Oxford University Press), William Niskanen concludes that the "initial Reagan forecasts did not deserve the later characterization as a 'rosy scenario'" (p.8). Like the other two books cited in this end note, he does not track the impact of the forecast in 1981 and 1982 on the deficit. (He does note, in passing, the failure of the 1982 forecast (p.228), but does not tie that failure to the issues addressed in this paper.)

¹¹ Stockman, The Triumph of Politics, 263. In his article cited in note 1 above, Sidney Blumenthal makes much of the Administration's failure to make a mid course correction in the summer of 1981.

¹²Stockman, The Triumph of Politics, 272.

¹³CBO, Baseline Budget Projections: FY1982-1986, p. xiv (July, 1981).

¹⁴ It is important to remember that the fiscal 1983 mistake is comprised of misestimates of the last quarter of the calendar 1982 economy and the first three quarters of calendar year 1983. Thus, the fact that all forecasts successfully predicted growth for calendar year 1983 is not as relevant as it might seem. Moreover, the misestimates of the GNP deflator in Table 4 are greater than those in Table 1.

¹⁵ See Reagonomics, note 10, at p. 8. Ironically, during the spring of 1981, the Reagan plan was criticized for being too inflationary because of expected deficits.

¹⁶ Of course, the Bush budgets for fiscal 1991 and 1992 broke the string of relatively accurate forecasts that began after those for fiscal 1983. Indeed, the budget for fiscal 1992, released in early 1990, became the mother of inaccurate budget projections.

¹⁷ The projected deficits were \$6.2 billion for 1982 and \$107 billion for 1983; actual deficits were \$128 billion and \$208 billion, respectively.

¹⁸ This argument does not deny that large increases in defense spending and decreases in taxes actually occurred. The point is that congressional refusal to follow Reagan's plans fully did not, considered in the aggregate with all of the spending and tax changes Reagan proposed, contribute significantly to the mistaken forecasts. The mistakes in the Congressional Budget Resolution (CBRs) for 1982 and 1983 were very close to those of Table 6. The total deficit underestimate was \$165 billion, \$135 billion (or 82 percent) of which resulted from faulty economic forecasts. OMB publishes these numbers regarding deficit mistakes in each President's Budget. CBO frequently publishes its estimates of the changes to the CRBs in its summer update.

¹⁹Reaganomics, note 10, at p. 293.