CHAPTER 15
GOVERNMENT AND THE POSTWAR AMERICAN ECONOMY

Government in the postwar American economy has continued to grow as both expenditures and taxes have grown faster than economic activity in general, a trend that, of course, stretches well back into the nineteenth century. Robert Higgs argues that in the twentieth century, and especially since the 1930s, government has grown not just in its scale of operations, which he calls *big* government, but, most importantly, has grown in its intrusiveness and control of private market activities, becoming the Leviathan or *BIG* government.[1] The result has been a deluge of laws to control and reshape economic activity in ways deemed appropriate by governmental bodies.

By the 1950s there were three relatively distinct government functions. For all governments, one function was the traditional *night watchman's* role of providing the foundation for a private market system through the definition and enforcement of private property rights, adjudication of disputes over private property rights, and provision of those goods and services that private markets would fail to provide or not provide in optimal amounts. A second function was to reshape private behavior in ways deemed socially responsible and to redistribute income in ways considered politically acceptable. Finally, in the Full Employment Act of 1946, the federal government adopted the objective of stabilizing aggregate economic activity and prices and promoting the maximum rate of economic growth. The pursuit of these objectives has led to a burgeoning government in the postwar period.

The Growth Of Government

The growth of government can be examined by looking at government employment, taxes and other receipts, or expenditures. Figure 15.1 presents government employment as a percent of nonagricultural employment for each year from 1950 through 1990. Employment by all governments grew steadily to 1975 and then declined, although the 1990 employment share is still higher than for any year before 1966. The federal government's employment share has, for the most part, declined since the early 1950s. As can be seen the bulk of all government employment resides at the state and local level.

Another measure that can be used is to examine the growth of government receipts, largely composed of tax collections. Figure 15.2 presents government receipts as a percent of GNP. For all governments, taxes collected have grown faster than GNP throughout the period. Different patterns are seen in the growth of federal taxes compared to state and local taxes. Generally federal receipts as a percent of GNP tended to slowly decline until the mid-1970s, however, the pattern is anything but smooth. Increases in federal tax collections in the early 1950s and late 1960s were associated with financing the Korean and Vietnam wars. Following 1975 federal receipts relative to GNP began to rise, and excluding the severe contraction of 1981-82 rose to 18 percent of GNP in 1989 and 1990.

State and local government receipts as a percent of GNP exhibit a different pattern. These tax receipts relatively increased until 1977, declined slightly through 1981 and have since been just less than the peak share in 1977. Thus, the trend of rising government tax receipts over the entire 1950-90 period is due to rising state and local government receipts from 1950 through the mid-1970s and rising federal receipts from the mid-1970s to the present.

Because the federal government can, and has, operated with budget deficits over long periods of time, government expenditures have grown faster than government receipts. Government expenditures as a percent of GNP are shown in Figure 15.3. Relative federal expenditures rose sharply during the Korean and Vietnam Wars. They also were relatively larger in the more severe recessions of 1974-75 and 1981-82. Adjusting for the war and recessionary increases, federal expenditures as a percent of GNP tended to rise little through the 1970s. In the early 1980s, federal expenditures rose sharply to 22 percent of GNP and, though declining somewhat in the late 1980s, remained above 20 percent of GNP and well above the relative level of federal government spending in the decades prior to 1980.

State and local government expenditures rose smoothly until 1975, then declined to 1984 and have since risen somewhat. The overall trend of rising government expenditures is thus due primarily to an increase in state and local government spending from 1950 through 1974, rising federal spending in the early 1980s, and rising state and local government spending in the late 1980s.

It is also useful to examine government spending in another way. Federal, state, and local government spending can be classified into two broad categories. First, there is spending on labor services and resources necessary to produce the goods and services that are distributed by nonmarket criteria to the population. Second, all levels of governments undertake transfers of income to selected recipients. Though some scarce resources are used to administer the income transfers, the income transfers do not use scarce resources. They do have affects in changing the demands for goods and services from what would have been the situation without the transfers and, to some disputed extent, alter the incentives to engage in productive and taxable activities.

Figure 15.4 presents government expenditures excluding transfers to persons.[2] Though showing considerable variation, all government expenditures (less transfers) as a percent of GNP shows no consistent trend to increase or decrease over the postwar period. Federal spending declined from the Korean War to 1980. By the late 1970s federal transfers to persons averaged 8.53 percent of GNP, or about 50 percent of all federal spending. State and local transfers to persons averaged only 2.35 percent of GNP, or about 17 percent of all state and local government spending. Through 1965 the rising state and local spending (less transfers) roughly offset the falling federal spending (less transfers), to hold the total government spending relative to GNP roughly constant. From 1965-79 declines in federal and (after 1975) state and local spending (less transfers) caused total government spending (less transfers) as a share of GNP to decline. A sharp increase in federal spending in the early 1980s combined with slightly rising state and local spending after 1984, caused all government spending (less transfers to persons) as a percent of GNP to be higher in the 1980s.

Figure 15.5 shows the sources of federal receipts as shares of total federal receipts. Throughout the postwar period the federal government has primarily relied on personal income taxes as a source of revenue. Corporate income taxes as a share of total receipts have fallen over most of the period. Historically, excise taxes have been a major source of federal revenue, but they also fell almost continuously in the postwar era. Estate and gift taxes have generally been less than 2 percent of federal revenues, and customs duties and fees have been less than 2 percent over the whole period. The primary growth in federal revenues came from social insurance taxes and contributions; the counterpart to the growth of federal transfers to persons.

Figure 15.6 shows selected categories of federal outlays as a percent of total federal outlays, and as can be seen, these have changed dramatically over the postwar period. National defense as a share of total federal outlays declined sharply from the Korean War to 1981. The Reagan administration's military buildup increased defense spending but its share had dropped back to the 1981 level by 1990. Net interest on the federal debt as a share of expenditures was roughly constant from the early 1950s to the late 1970s, but increased sharply from just over 7 percent in 1975 to 10 percent in 1981 to nearly 15 percent by 1990. Agricultural outlays have steadily declined and were less than 1 percent of expenditures by 1990, while commerce and transportation have consumed about 3 to 6 percent of federal outlays with no noticeable trend of growth or decline. Veterans benefits and services have almost disappeared.

The two categories that have grown sharply are income security and education, labor, and health. Income security includes Social Security outlays, unemployment supplements to state governments, pension outlays for miners and railroad workers, the food stamp programs, grants to states for Aid to Families with Dependent Children, and other income transfer programs. (Prior to 1975 Social Security was not reported separately from these other programs.) These programs, particularly Social Security transfers, grew rapidly from 1952 through 1961 and from 1969 through 1976. Since 1975, Social Security outlays as a percent of total federal outlays have remained essentially constant at about 20 to 21 percent, while other income security outlays have declined from 16.68 percent to 11.77 percent of all federal outlays.

In a similar fashion, Medicare was not reported separately from education, labor, and health outlays until 1975. Programs to improve training, health, and, later, education grew rapidly after the mid-1960s, growing from less than 3 percent of all federal outlays in the early 1960s to nearly 13 percent by the mid-1970s. Medicare has continued to grow since 1975, from less than 4 percent of federal outlays to 7.84 percent in 1990. Other education, labor, and health outlays reached over 10 percent by 1979, declined to less than 7 percent by 1987 and have since risen to 7.69 percent in 1990.

Figure 15.7 shows selected state and local government revenues as a percent of total state and local government revenues. In the early 1950s over 34 percent of these revenues came from property taxes, however, growing revenue demands and property owner resistance decreased the importance of this revenue source. The other longtime cornerstone of state and local government revenues is sales and gross receipts taxes, and this share declined gradually over the period. Corporation net income taxes changed little in the postwar era. The growth in state and local government revenue stems primarily from the growth in individual income tax collections and revenue sharing from the federal government.

Individual income taxes rose from less than 4 percent of all revenues to over 12 percent. Federal revenue sharing had grown from 10 to over 21 percent by the end of the 1970s, but this share declined to 16 percent by 1989. State and local governments also collect many other fees and charges, such as drivers' license and license plate fees, and park use fees. These increased from over 23 percent of all revenues to 29 percent in the 1980s.

State and local government expenditures by broad categories are shown in Figure 15.8. Education has generally been the largest single expenditure item. The other two large categories are highways and public welfare. State and local highway construction as a share of all expenditures declined from the end of the 1950s to the early 1980s. Public welfare outlays as a share declined in the early 1950s, were roughly constant to 1966, and then rose sharply as President Johnson launched his war on poverty. The share has changed little since the early 1970s. The "all other" category includes such diverse expenditures as state and local police, fire protection, sanitation services, parks and recreation, and all of the rest of the varied state and local services. These expenditures have been rising since the late 1950s.

Only the federal government can run nearly continuous deficits and it has done this in the postwar era. This behavior, in fact, is a significant change. Deficits during wars and severe economic contractions built up debt that was reduced by surpluses generated in most other years. Several times in the nineteenth century the national debt nearly disappeared. In the postwar era federal budget surpluses have become a vanishing species. Figure 15.9 presents the federal surplus or deficit as a percent of GNP, and, as can be seen, the last federal budget surplus was in 1969.

Continuing deficits mean increases in the federal debt. Figure 15.10 shows the federal debt as a percent of GNP and the shares of the debt held by major holders. The ratio of the federal debt to GNP fell sharply through the early 1970s and more gradually through the rest of the 1970s. This occurred for two reasons. First, GNP grew faster than the federal debt did, causing the ratio to fall. Second, once issued the outstanding debt remains fixed in nominal value, and so the continuing postwar inflation engineered by the Federal Reserve System began reducing the real value of the debt. The Reagan budget deficits of the 1980s led to an explosion of the debt. The real debt rose from $1,060.1 billion in 1980 to $2,439.2 billion in 1990. The federal debt as a percent of GNP reversed its long decline and rose from 34 percent in 1980 to 59.3 percent in 1990.

Who has held the debt during the postwar era has also varied. The largest share has been held by the public (a grouping which includes all foreign, corporate, and financial institution holdings). The public's share declined to 1974 and rose to the mid-1980s. The next largest holder of the federal debt is the federal government itself, primarily the Social Security Trust Fund, which, by law, must invest collections in excess of disbursements in U.S. government securities.[3] The share of the federal government debt held by the Federal Reserve System was roughly constant through the 1950s and then began rising to a peak of 16.6 percent in 1974. Since then, the holdings of the Federal Reserve System have fallen to 7.3 percent in 1990. Heavily criticized for the higher rates of price inflation of the 1970s, the Federal Reserve System was unwilling to acquire more of the debt. To have done so would have meant a larger increase in the monetary base, the stock of money, and almost certainly the rate of price inflation. Such behavior would have resulted in a quite different monetary policy, a topic we now turn to.

Fig. 15.1. Government Employment as a Percent of Nonagricultural Employment

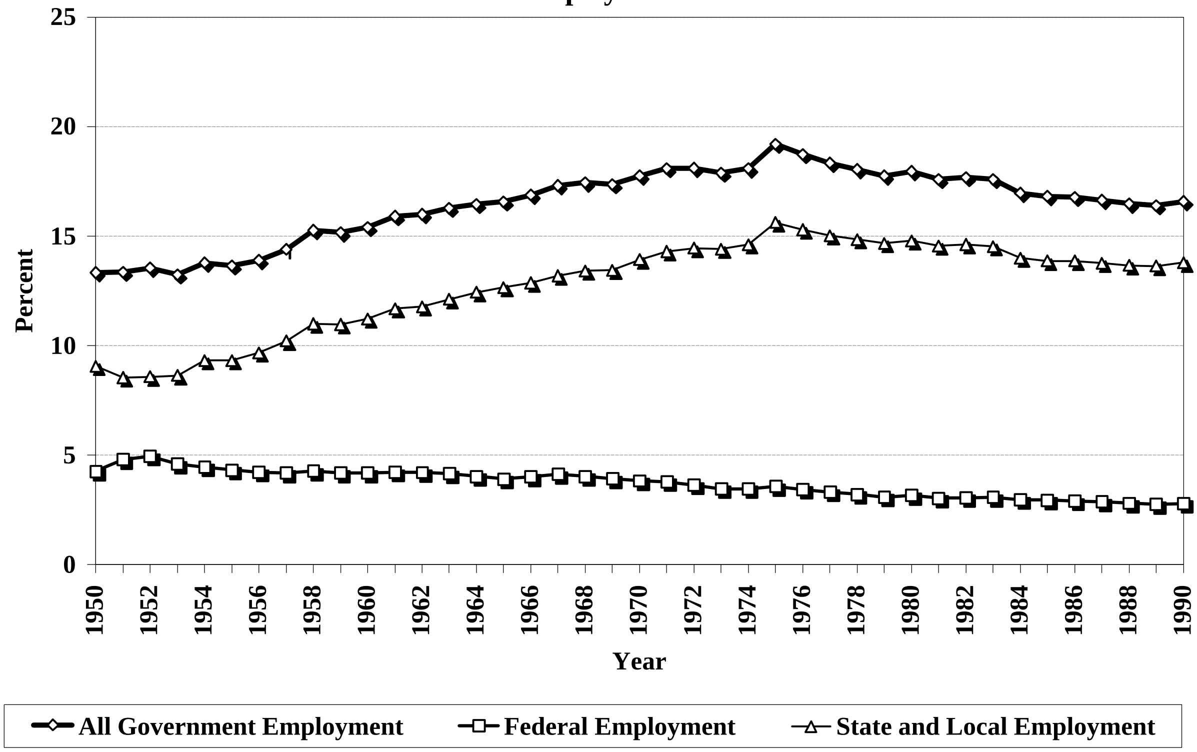


Fig. 15.2. Government Receipts as a Percent of GNP

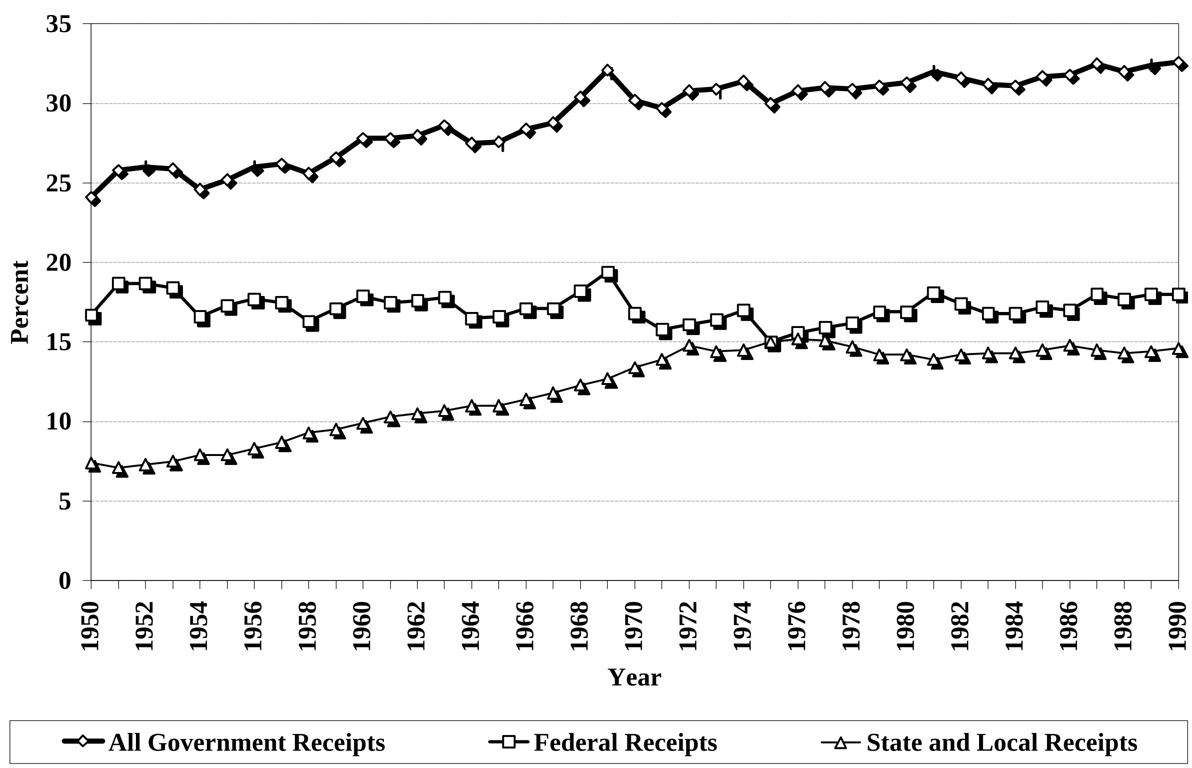


Fig. 15.3. Government Expenditures as a Percent of GNP

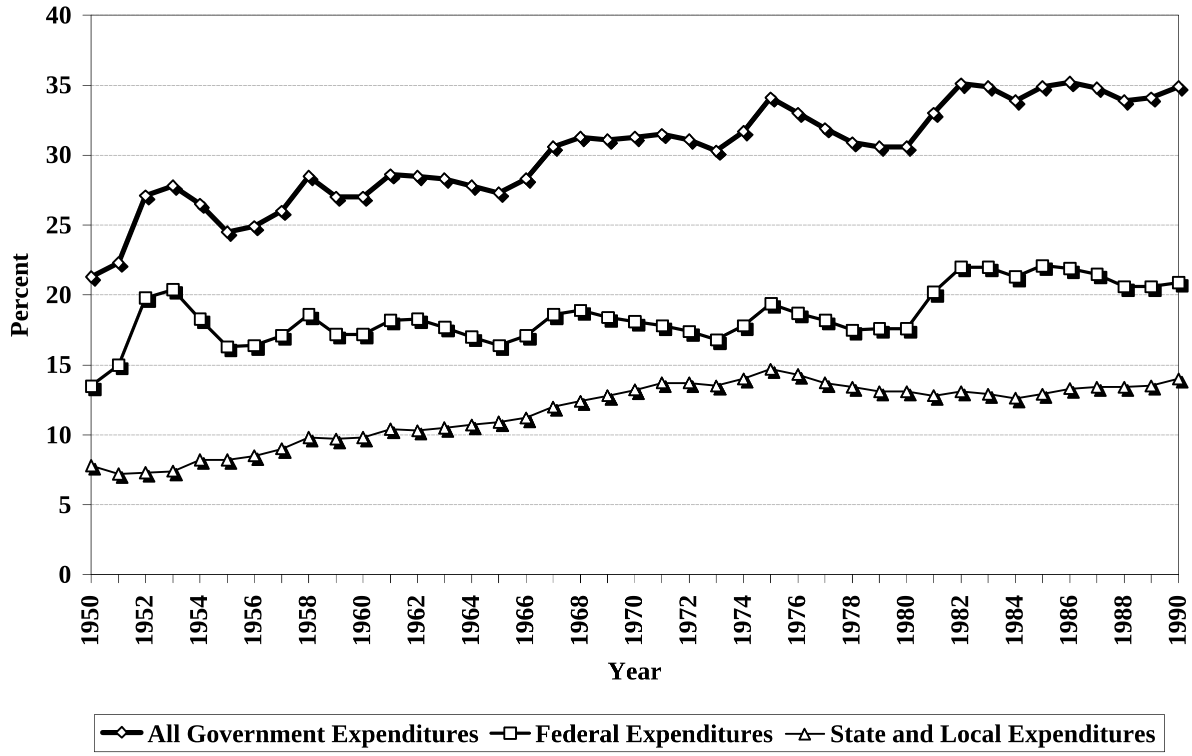
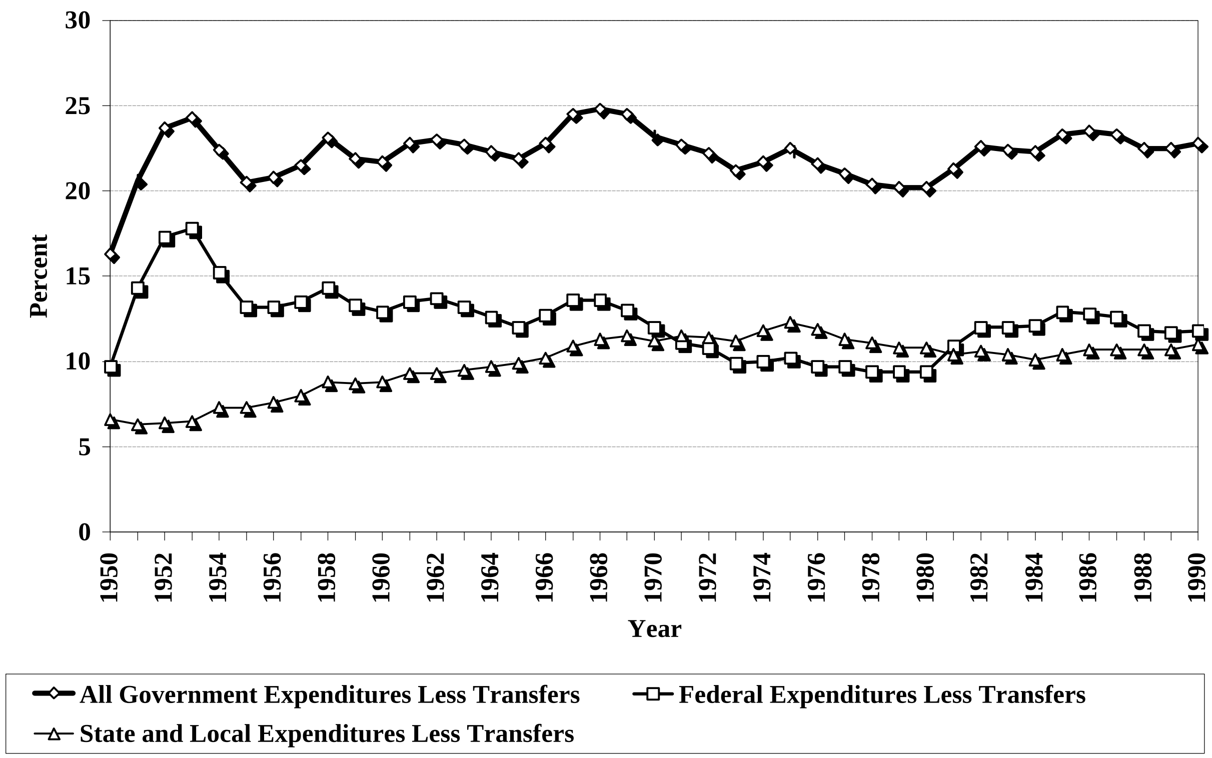


Fig. 15.4. Government Expenditures less Transfers to Persons as a Percent of GNP



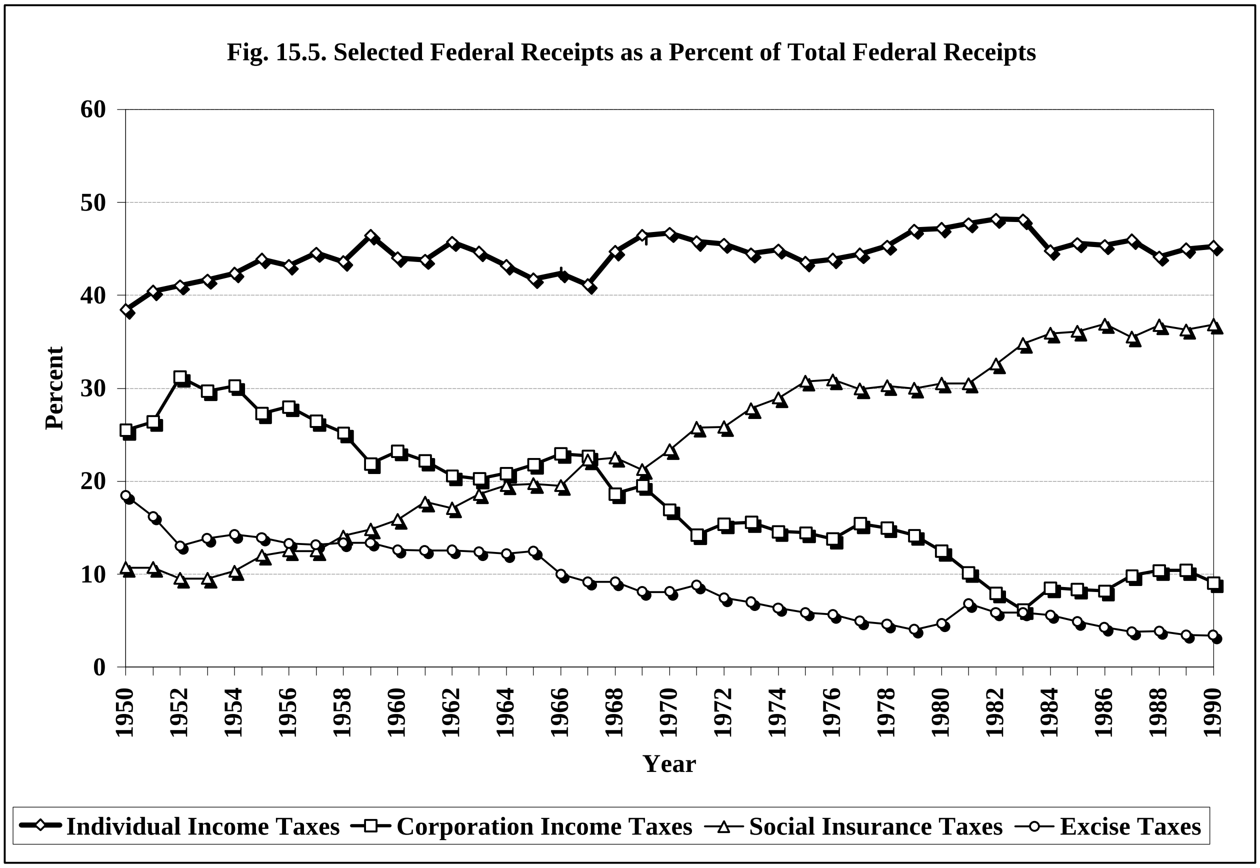


Fig. 15.5. Selected Federal Receipts as a Percent of Total Federal Receipts
Percent
Year
Individual Income Taxes
Corporation Income Taxes
Social Insurance Taxes
Excise Taxes

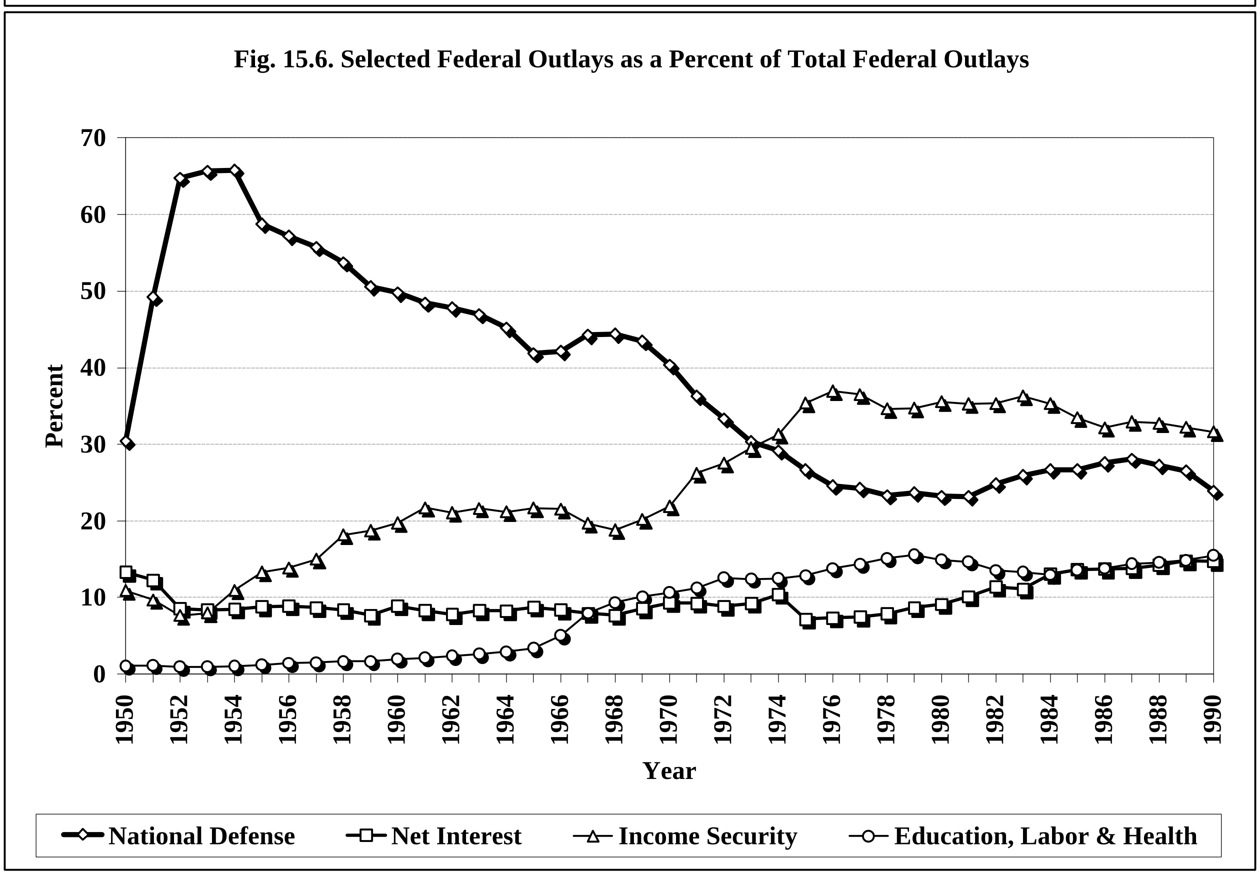


Fig. 15.6. Selected Federal Outlays as a Percent of Total Federal Outlays
Percent
Year
National Defense
Net Interest
Income Security
Education, Labor & Health

Fig. 15.7. Selected State and Local Government Revenues as a Percent of Total Revenues

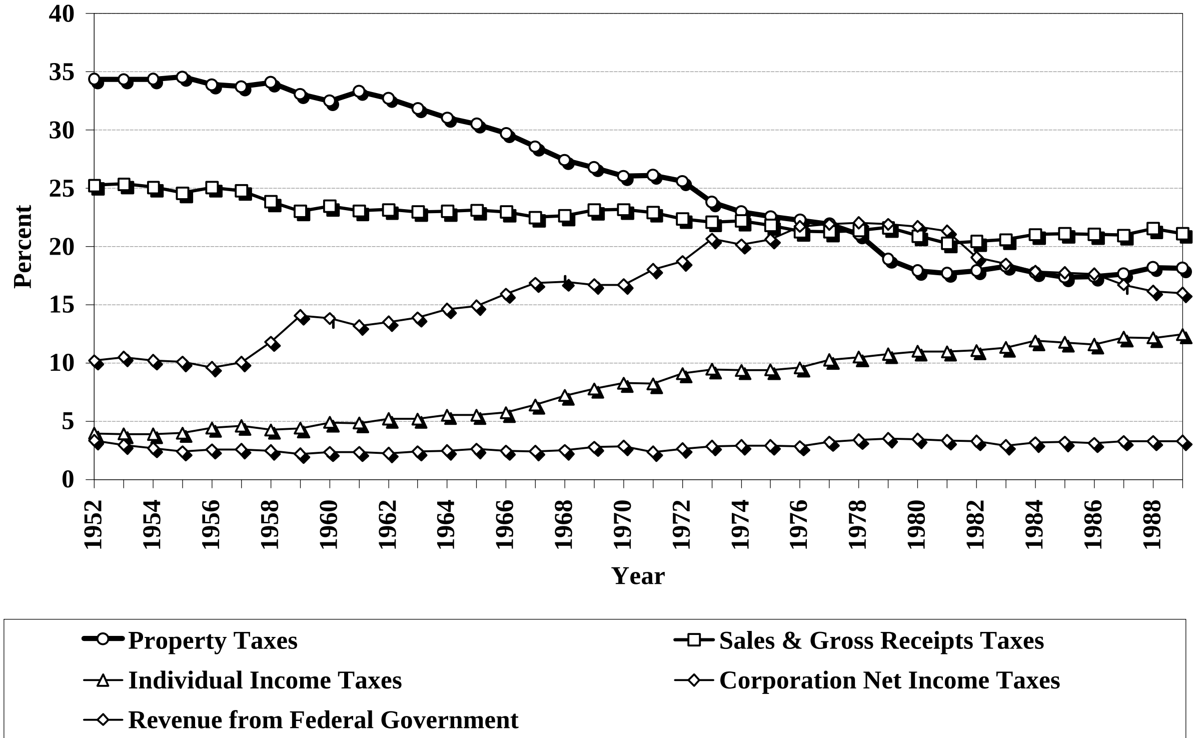
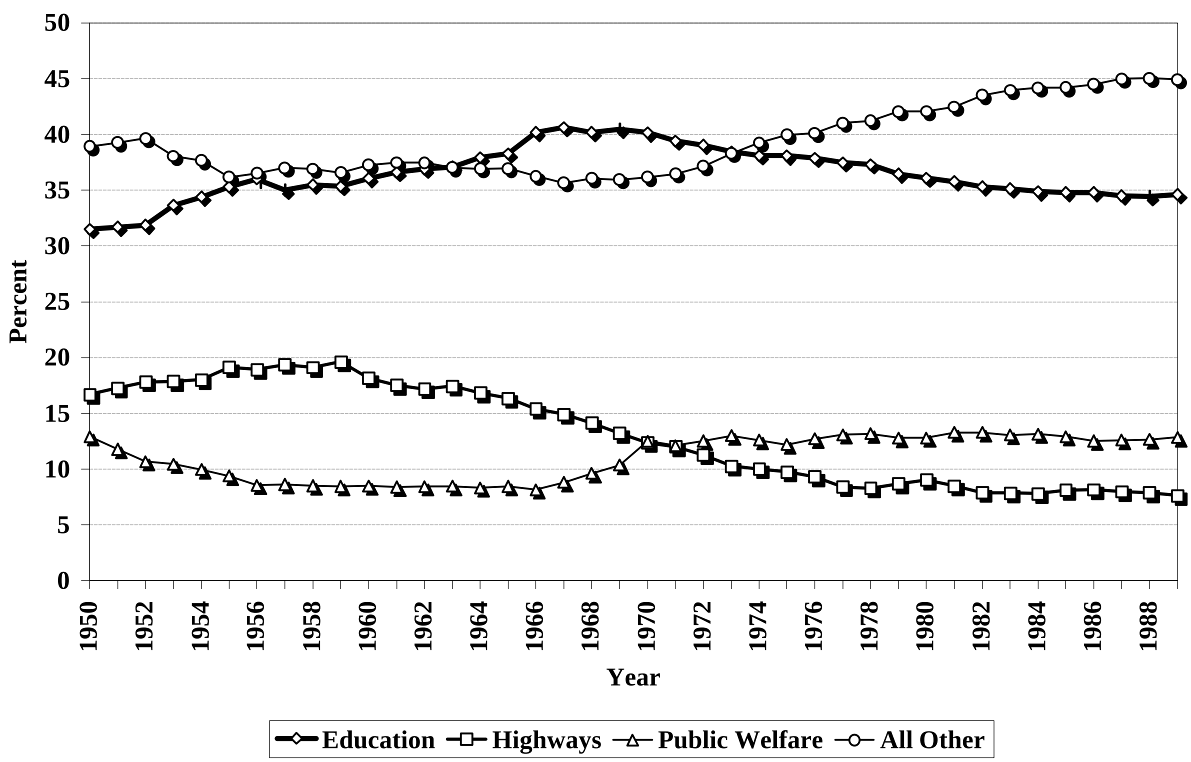


Fig. 15.8. Selected State and Local Government Outlays as a Percent of Total Outlays



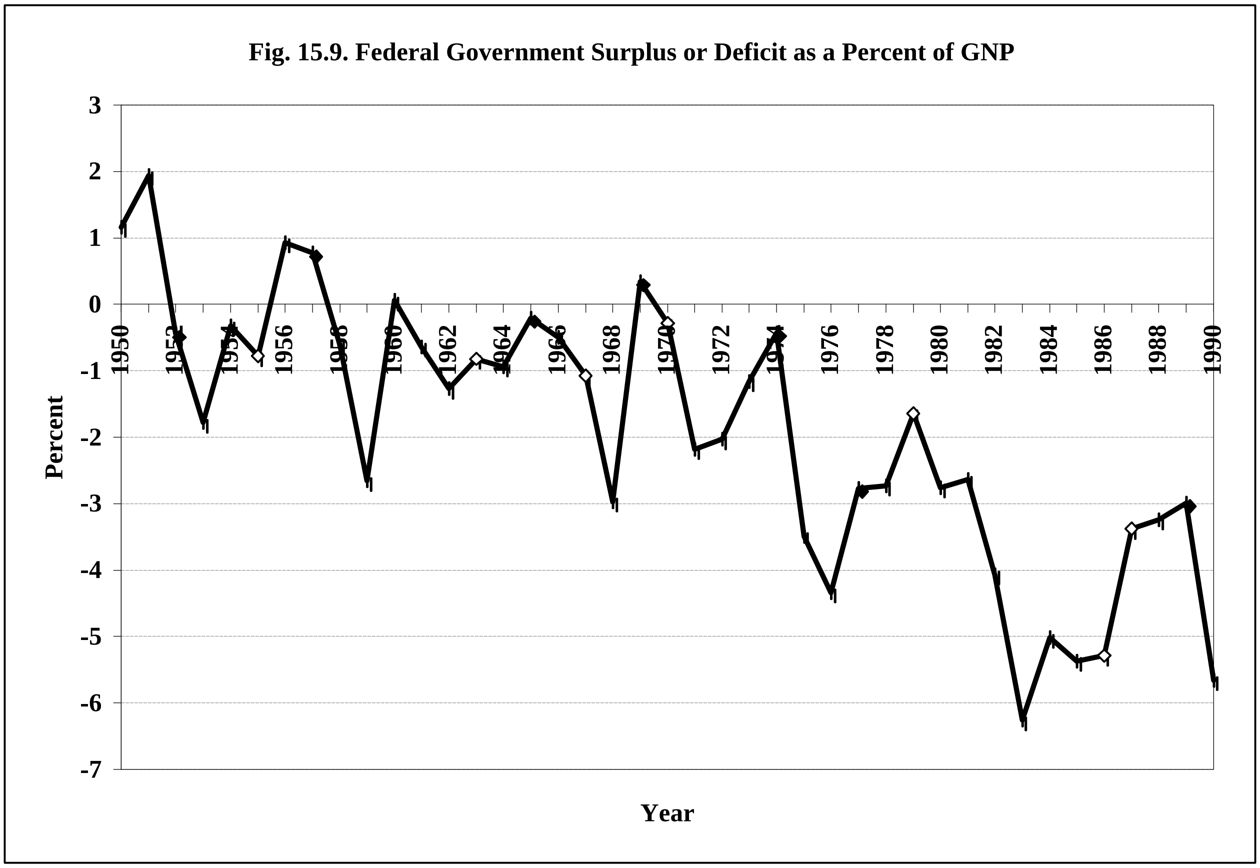


Fig. 15.9. Federal Government Surplus or Deficit as a Percent of GNP
Percent
Year
3
2
1
0
-1
-2
-3
-4
-5
-6
-7
1950
1952
1954
1956
1958
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990

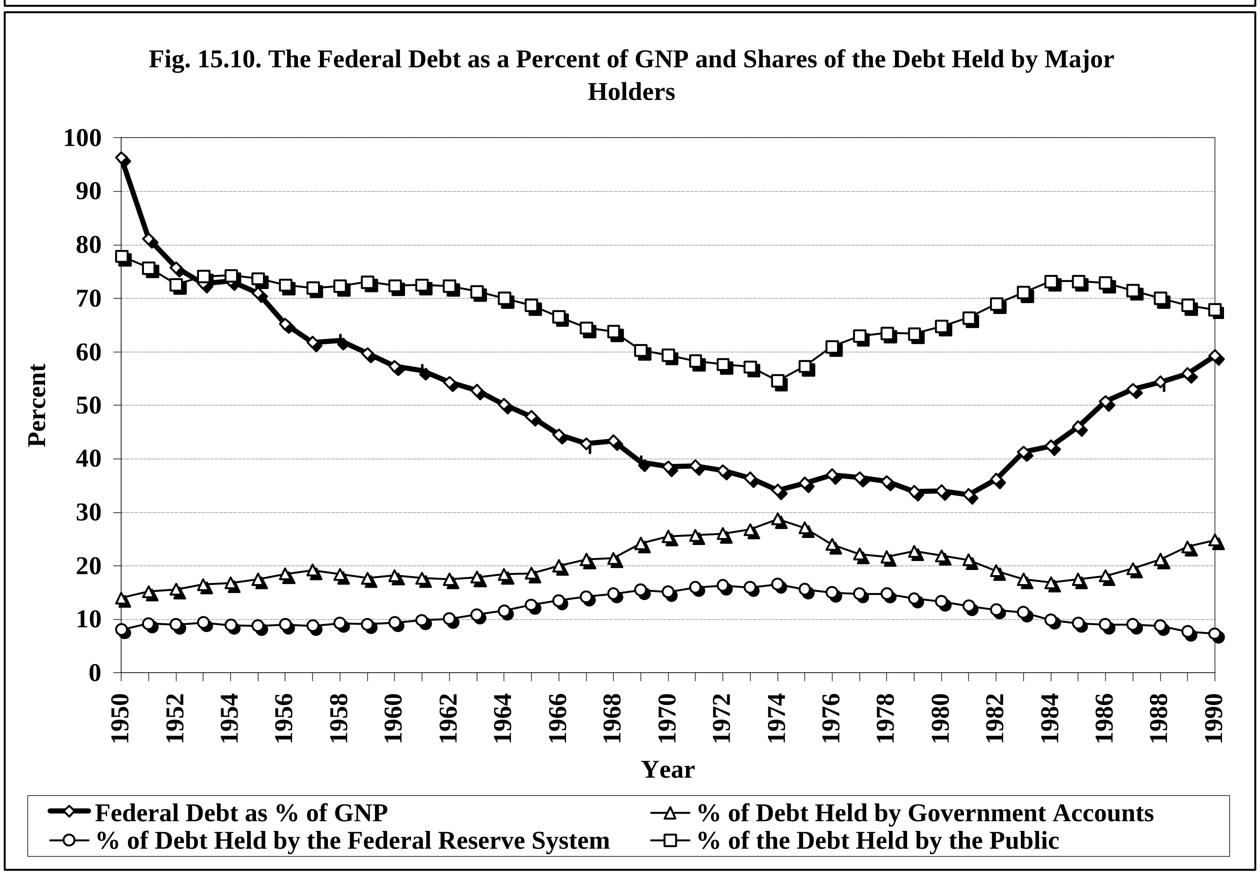


Fig. 15.10. The Federal Debt as a Percent of GNP and Shares of the Debt Held by Major Holders
Percent
Year
100
90
80
70
60
50
40
30
20
10
0
1950
1952
1954
1956
1958
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
Federal Debt as % of GNP
% of Debt Held by Government Accounts
% of Debt Held by the Federal Reserve System
% of the Debt Held by the Public

Stabilization Policies

Policies to stabilize economic activity and achieve the goals of the Full Employment Act of 1946 are conducted by the Federal Reserve System and the federal government.[4] Though the Federal Reserve System was ostensibly created as a quasi-independent agency, in practice it has generally coordinated its policies with those of the federal government and not swayed too far from the wishes of Congress. It was quickly realized that there were problems with fiscal policy conducted by the federal government. Deciding what to do and then acting upon that decision was slow and difficult because of the necessity of getting agreement between the House of Representatives, the Senate, and the administration. The lags necessitated by this decision-making process, added to the lags in recognizing changes in economic activity, have been a problem for stabilization policies throughout the postwar period.

The Late 1940s and 1950s

During the war there were several proposals that the federal government should have a national policy aimed at achieving full-employment. In 1945 a bill was introduced to make full-employment a national goal by setting federal expenditures at whatever level was necessary to attain this.[5] The bill was an outgrowth of Keynesian ideas that government could control or moderate cyclical fluctuations such as had occurred in the interwar era,[6] and was also a response to the emerging role of the U.S. dollar as the new international legal reserve currency.[7]

What emerged in 1946 was considerably weaker than the first proposals. Instead of "full" employment the objective was to achieve "high" employment. The "right" of each person to work was eliminated, as were the requirements for a national budget that would forecast actual and full-employment demand for the president to take steps to initiate programs to close the gap if one existed. Republicans and business interests saw this as opening the door to national planning by the federal government as well as to the possibility of unlimited federal deficits.[8] The act did create a three-person Council of Economic Advisors and directed the president and the council to submit an economic report in January of each year. The Employment Act of 1946 was the first explicit statement of the federal government's responsibility to promote maximum employment, production, and purchasing power. Harry S. Truman was the first president to operate under the new act, but his "Fair Deal" undertook little in the way of stabilization policy. Truman vetoed bills to cut tax rates from the high wartime levels, and Congress found that much of the federal budget was uncontrollable.[9]

Herbert Stein argues that something of a consensus had developed in the interval between the end of the Second World War and the Korean War. The aim of fiscal policy was to be stabilization of economic activity, and the annual balancing of the federal budget was to be avoided if this interfered with stabilization.[10] Though fiscal policy was the primary stabilization tool, it had drawbacks. Forecasts were too unreliable, fiscal actions were too slow, and it could not be assumed that fiscal policy would be devoted exclusively to stabilization. Thus, the Fed's monetary policy, which had been relegated to a virtually nonexistent role after the early 1930s, was to become more flexible in its role of supporting fiscal policy.[11]

However, until 1951 monetary policy was constrained in attempting to implement any stabilization policies. After the war, the Fed continued its wartime policy of maintaining low interest rates and higher government bond prices.[12] The Treasury wanted to ease refinancing requirements as they arose and both the Fed and the treasury feared "disorderly" financial markets and problems for the financial institutions, which held large amounts of federal government securities, if interest rates rose and securities prices fell. However, differences between the Fed and the Treasury arose.[13] Though long-term rates were "pegged" at 2.5 percent, the Fed wanted to allow short-term rates to rise and made moves in this direction in 1947 and 1948. Throughout 1949 and 1950 discussions between the Fed and the Treasury continued on which rates to peg and at what level.

With the beginning of the Korean War on June 25, 1950, the struggle between the Fed and the Treasury intensified. Throughout the rest of 1950 and into early 1951, the Treasury, President Truman, Congress, and the Fed continued to discuss and disagree in public and in private as to what should be done. Finally, on March 3, 1951, a brief announcement was issued stating that the Treasury and the Fed had reached an accord. For the first time since prior to the Second World War, the Fed was freed to exercise discretionary monetary policy. The initial accord was limited to freeing the Fed on short-term rates, and the Fed did not stop supporting the prices of government securities. Not until 1953 "did the System explicitly forswear support of the prices of government securities as an aim of policy."[14]

There were three minor recessions during the Eisenhower years—1954-55, 1957-58, and 1960-61. The federal government relied upon the automatic stabilizers of the progressive income tax system and unemployment compensation payments rather than taking discretionary actions.[15] The Fed, under William McChesney Martin, Jr., relied upon open-market operations primarily through the purchase and sale of short-term bills for the monetary policy that it undertook.[16]

The 1960s

The focus of stabilization policies in the decade of the 1960s was on fiscal policy. For the first time an administration explicitly used Keynesian theory in attempting to direct activity within the economy. The expansion that began in February of 1961 continued until December of 1969 and became the longest on record. The new president, John F. Kennedy, brought in leading Keynesian economists as his advisors. As a group these economic advisors were more willing to consider market intervention to obtain their desired results; they were less concerned with inflation and more enamored of the idea of an inflation-unemployment trade-off, the so-called Phillips Curve. Kennedy's advisors were worried that the high tax rates and potential budget surpluses at full-employment would stop the economy from achieving full-employment. They believed that balance-of-payments deficits prohibited the use of monetary policy because lower interest rates would have exacerbated the deficits. This left only fiscal policy as the means to stimulate the economy, and they believed that this should be done through tax reductions, something Congress was generally sympathetic to. Because Kennedy had campaigned on a platform of balanced budgets and expanded spending, he had to be gradually converted to this Keynesian view.

The decision to cut taxes was not adopted until June 7, 1962, and Kennedy announced that he would propose an across-the-board reduction of individual and corporate income taxes to take effect January 1, 1963. First the House and then the Senate held up the bill, and it had not moved in the Senate on November 22, 1963, when Kennedy was assassinated. Lyndon Baines Johnson then took over the bill and agreed to hold down spending as requested by the Senate Finance Committee. After the budget appeared, the bill was reported out of the Senate Finance Committee on January 28, 1964. The Senate-House differences were ironed out by February 26, 1964, and Johnson signed the bill the same day.[17]

The act reduced taxes by about 20 percent on average with the first part of the reduction in 1964, and the final part in 1965. Withholding rates and corporate tax rates were also reduced. The result, in conjunction with a defense buildup and the onset of Johnson's War on Poverty, was to eliminate the full-employment budget surplus that the Keynesians had calculated. The Federal Reserve System contributed by increasing the rate of growth of the stock of money in 1964 and 1965.

This episode was really the first conscious use of Keynesian theory to formulate fiscal policy. In some ways, however, this was not a stabilization policy because the stated long-run purpose was to move the economy to a higher level of employment during the recovery and increase the rate of economic growth—not to promote recovery from a contraction. It also took a long time to obtain the tax cut. First proposed by administration economists in 1961, the bill was not signed until late February of 1964. Only about half the tax cuts took effect in 1964, with the rest effective in 1965. Therefore, it took nearly four years for the proposal to become a reality.

By 1966 the economy was at full employment, and prices were rising more rapidly. President Johnson resisted recommendations to raise taxes to reduce excess demand and lower inflationary pressures, but the Fed did increase the discount rate and reduce the growth of the monetary base in 1966, producing a credit crunch. In January, 1967, Johnson proposed a 6 percent surtax on corporate and personal income taxes, and Social Security tax rates were increased to provide for a congressionally mandated benefits increase. The Fed eased up on monetary policy. Congress finally passed a temporary surtax for the 1969 fiscal year. Savings, but not spending, declined, and the Fed adopted an easier monetary policy. As a result, the only significant change was the last federal budget surplus. Monetarist forecasts of economic activity were quite good during this period, providing support for their contentions on the power of monetary policy compared to fiscal policy.[18]

The 1970s

Robert Degen has suggested that "there is a certain morbid symmetry about our monetary experiences in the 1970s: the decade began and ended in an atmosphere of crisis, deflation, and reform of the Federal Reserve methods of operation."[19] Richard M. Nixon, a Republican president who supposedly abhorred comprehensive controls, went ahead and imposed them. The Bretton Woods international financial system created at the end of the Second World War collapsed and was replaced by a system of floating exchange rates.

With Richard Nixon's assumption of the presidency in 1969, something of a conservative trend in economics and politics took effect; monetary policy began to play a more important role. Keynesian-style fiscal policy appeared to be unable to constrain the rising price inflation and was being more seriously questioned both inside and outside of academia.[20] Arthur Burns, in his new role of chief architect of the nation's monetary policy, apparently felt constrained by the 1970 recession and a financial crisis initiated by the June, 1970, Penn Central collapse. Monetary policy had to be eased to handle these situations. However, this conflicted with the goal of gradually reducing the growth rate of the stock of money to lower inflation without bringing on a contraction. Prices continued to rise during the 1970 recession. During 1970 and 1971, Burns came to believe that wage-price guidelines could effectively supplement monetary policy in reducing the rate of inflation.[21] Congress was also pushing for guidelines and in early 1970 passed the Economic Stabilization Act, giving the president the authority to impose economic controls. Nixon initially disavowed their use, but by early 1971 several aspects of an incomes policy had been employed.[22]

Still, the sudden imposition of wage and price controls on August 15, 1971, was a nearly complete surprise. There were four phases to the wage and price controls. Phase I froze wages, prices, and rents for 90 days. At the same time, a 10 percent investment tax credit was passed, excise taxes on automobiles and trucks were eliminated, personal exemptions were increased, and some revenue sharing programs were canceled. On the international agenda, the dollar was devalued and convertibility suspended. The dollar was again devalued in February, 1973, and in March, 1973, the United States went to a floating exchange rate, effectively ending the Bretton Woods System.[23]

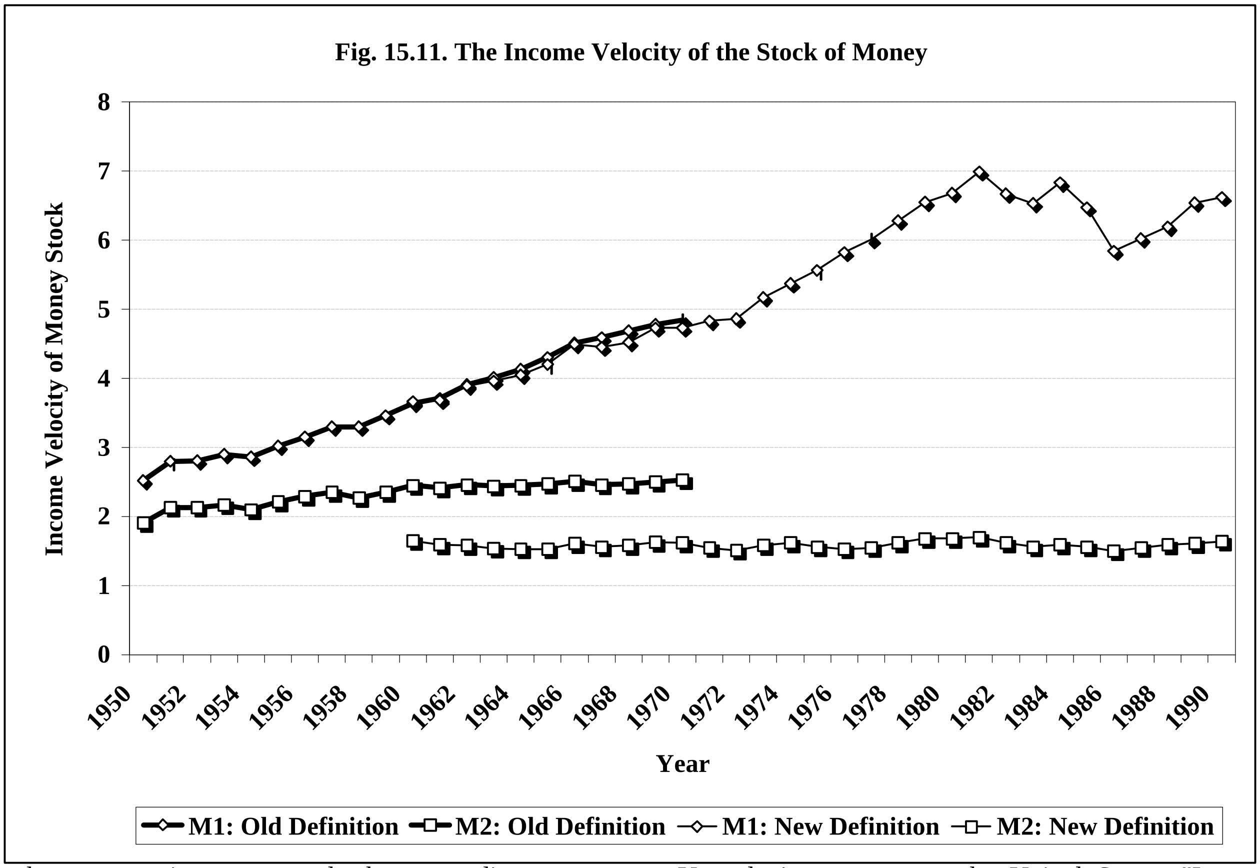
Phase II established a mandatory system of wage and price controls to allow for controlled adjustments. Phase II lasted through 1972, when Phase III began. Phase III moved toward voluntary controls and a greater reliance on market adjustments. However, prices rose rapidly under Phase III. The administration's response was to impose a 60-day freeze on many wages and prices in June of 1973. The public response was poor and many distortions appeared, particularly shortages of various food products. Phase IV was introduced in August 1973 and industries began to be decontrolled. Finally, on April 30, 1974, all wage and price controls were terminated.[24]

Most economists agree that the wage and price controls did not work. By creating supply uncertainties and resource misallocations, they reduced production, causing even higher prices. For the most part, profit margins of firms were reduced rather than holding back wages at the same rate as prices were restrained. This suggested that once the controls were removed, there would be a catch-up in price inflation, an event that did occur. Price increases during the period of controls from August 15, 1971, to April 30, 1974, cannot measure inflation because prices were controlled and not free to measure the inflation that was occurring. As Robert J. Gordon pointed out in 1973, the wage and price controls had no long-run effect on inflation.[25] In his survey and analysis of wage and price controls in the early 1970s, Rockoff found that "many professional economists have agreed that the Vietnam episode with controls was especially unsuccessful."[26]

The Federal Reserve System's basis for monetary policy was also changing throughout the early 1970s. Under Arthur Burns, the Federal Reserve System began to emphasize various monetary aggregates as well as money market conditions. The 1970s became a transition decade for the Federal Reserve System as its operating procedures evolved to combine "monetary aggregates as intermediate targets with reserves and interest rates as operating targets."[27] Congressional pressure to make the Fed more accountable to Congress led the board of governors to begin reporting money growth targets to the Senate in May of 1975, and legislation in 1977 and 1978 expanded this.

In the early 1970s, these changes were still in their infancy and, when combined with the varying phases of wage and price controls, led to erratic monetary policy. A series of economic "shocks," or rapid changes, in 1972 and 1973 helped usher in a recession. These were the devaluation and floating of the American dollar, sharply rising prices of many foodstuffs (such as wheat), reduced supplies and huge price increases for crude oil and gasoline, and the April, 1974 removal of all wage and price controls.[28] By November of 1973, these supply shocks and the distortions caused by wage and price controls had brought on a recession. With the lifting of wage and price controls, the long-repressed inflation quickly resulted in rapid price increases even though the recession was underway and continued until March of 1975. The rate of inflation, measured by the change in the CPI, peaked at 12.2 percent around the middle of 1974 and averaged 11 percent for the entire year. The rate of unemployment averaged 8.3 percent for all of 1975.

Gerald R. Ford, who became president when Richard M. Nixon resigned, was initially concerned with the double-digit inflation. His attention soon shifted to the recession as he proposed tax cuts and rebates in the Tax Reduction Act of 1975. Most economists believe that the 1975 tax cuts were, at best, ineffective. The recession ended before the rebates on 1974 taxes were in the hands of consumers.[29] The temporary nature of the tax cuts also suggested that consumers might save these rather than spend the extra disposable income. In addition,



other economists suggested that crowding out reduced the effectiveness of the tax cuts.[30]

Following the 1974-75 recession, there was great variability in the rate of growth of the stock of money, and the rate of price inflation began to accelerate. The Carter administration proposed voluntary wage and price guidelines to reduce the rate of price inflation, but these were ineffective. Monetary policy under Arthur Burns and, after January of 1978, his replacement, G. William Miller, can best be described as erratic. As inflationary expectations increased, these became incorporated into nominal interest rates, causing interest rates to increase, and by the end of the 1970s nominal interest rates were historically very high. Higher interest rates led to growing losses at banks and thrifts. Further complicating the Fed's monetary policy was the growth of the income velocity of money at the end of the 1970s; a trend which forecast worsening inflation. (See Figure 15.11.)

When Paul Volcker replaced Miller in the middle of 1979, the financial sector was in a dreadful state.[31] The rate of inflation and the fall of the dollar in the foreign exchange markets both accelerated in the months prior to October of 1979. As turmoil enveloped the financial markets, Robert Degen reports that Paul Volcker abruptly left an International Monetary Fund meeting in Belgrade, Yugoslavia to return to the United States. "In an extraordinary meeting of the Federal Open Market Committee on Saturday night, October 6, 1979, quickly deemed 'historic' by financial writers, the Federal Reserve adopted a new policy stance."[32]

This new policy stance was apparently strongly influenced by the Monetarists. The Federal Reserve System announced that it would begin targeting the unborrowed reserves of the member banks rather than the federal funds rate. The announcement was hailed by Monetarists everywhere as a serious attempt to reduce the growth rate of the stock of money and begin reducing the rate of price inflation. To reinforce the policy change, the Fed sharply increased the discount rate to 12 percent and increased reserve requirements on selected accounts such as Eurodollar accounts. With the announcement, interest rates began to rise, and the dollar's foreign exchange value stabilized. These changes led the way into the macroeconomic policies of the 1980s.

The 1980s

Large segments of the American population had become increasingly dissatisfied with government in the 1970s. Taxes and the sizes of government seemed to continually grow at a faster rate than the incomes of ordinary citizens.[33] In 1980 Ronald W. Reagan campaigned for the presidency on what was essentially an antigovernment platform, proposing that federal taxes be cut to stimulate the supply of savings and investment and boost productive economic activity. The size of the federal government was to be reduced along with federal regulations on businesses to allow firms to be more productive and enable free markets to more fully direct the allocation of the nation's scarce productive resources. With this anti-Washington theme Reagan won the election over the incumbent president, Jimmy Carter.

Reagan was proposing the adoption of what had come to be called supply-side economics, and the full set of his administration's economic programs, of which supply-side economics was an integral part, was frequently referred to as "Reaganomics."[34] Supply-side economics argued that increases beyond a certain tax rate led to decreases in tax revenues as productive taxable activity was choked off. The more extreme supply-side positions argued that in the late 1970s tax rates were so high that reductions in federal tax rates could actually increase federal tax revenues. Other less extreme positions argued that tax rate reductions combined with spending cuts could provide the economic stimulus to get the economy growing faster and end "stagflation." Supply-siders also argued that the historical record showed that sharp tax rate reductions actually increased the share of the tax burden borne by the higher income taxpayers who, because of progressive tax rates, would have greater absolute reductions in tax rates.

The program proposed by newly elected President Reagan combined these supply-side ideas with more traditional conservative concepts. The most important component was reductions in personal federal income tax rates amounting to an average of 25 percent over a three-year period. When fully phased in, the top marginal rate was to drop from 70 to 50 percent, and rates would be indexed against future price inflation. This was the most important of the tax cuts. Federal spending growth was to be reduced by cutting almost all nondefense spending, excluding Social Security, and regulations that raised business expenses unnecessarily or reduced competition were to be reduced or eliminated. Finally, the Federal Reserve System, under Paul Volcker, was asked to restrain the growth of the stock of money in a monetarist fashion to bring down the rate of price inflation.

These reductions were enacted in the Economic Recovery Tax Act, which President Reagan signed on August 13, 1981.[35] In 1985, after his reelection, President Reagan again requested cuts in personal income tax rates, which, beginning in 1986, were lowered to a maximum of 28 percent with a reduction in the number of rate brackets and elimination of many tax breaks.[36] In 1981 the Office of Management and Budget used highly optimistic estimates of inflation, interest rates, and economic growth to predict that the economic program would result in a balanced budget by 1984.

However, the Reagan administration's program got off to a much different start. The October, 1979, change in monetary policy allowed interest rates to begin rising sharply. As bond yields rose, bond prices fell, and 1980 became known as the year of the great bond market crash as banks, thrifts, and insurance companies saw the value of their bond portfolios decline dramatically. A short recession began in January of 1980 and ended in July of 1980. In the meantime, interest rates continued to rise. Short-term interest rates reached nearly 20 percent in 1981, while new mortgage yields were around 15 percent in 1981 and 1982. The rate of inflation averaged nearly 13 percent during 1981. A new recession began in July 1981 and did not end until December of 1982. This was the longest and most severe postwar contraction. In December of 1982, the unemployment rate hit 10.8 percent.

Many analyses argue that the length and severity of the contraction was due to the Federal Reserve System's policies to quickly lower the rate of price inflation. However, the accelerating inflation of the last half of the 1970s had generated severe price distortions and malinvestments that were exposed once the rate of price inflation dropped sharply. For example, firms that had expanded often chose debt instruments that were poorer choices in a disinflating environment. Farmers had been lured by rising land and crop support prices—which were significantly driven by the price inflation—and low real interest rates to expand and go into debt which could not be sustained in a low-inflation, higher real interest rate environment. With the disinflation and much higher real interest rates of the 1980s, these massive dislocations in the agricultural sector as well as dramatic adjustments for nonagricultural firms were unavoidable.

The Reagan administration had counted on a rapid supply-side-driven recovery from a mild contraction to meet its projections. The actual result was a rapid and dramatic rise in federal budget deficits. The peacetime federal deficits incurred under the Reagan administration during the 1980s had no precedent in the history of the United States. The deficits and public criticism of the federal government spurred Congress into action in late 1985, and it passed the Gramm-Rudman bill, an act supposed to automatically trigger across-the-board spending reductions if projections of the federal deficit exceeded legislated maximums. The bill had little effect.

Monetary policy in the 1980s also followed a rocky path. By 1982 the Monetarist-type policy of controlling the growth of unborrowed reserves of the banking system, announced with such fanfare in October of 1979, had been abandoned. The Monetarist proposals were formulated on the basis of a relatively stable income velocity of money. However, as Figure 15.11 shows, in the 1980s the M1 income velocity of money became quite variable.[37] Interest rate ceilings on time and savings deposits were gradually raised and eliminated in 1986. Checking accounts began to pay interest and the incentives to minimize balances in checking deposits to hold funds in interest bearing time or savings deposits were minimized. Confronted with new deposit accounts, which blurred the distinction between transactions balances and short-term investment funds, the Fed again began to redefine the monetary aggregates.[38]

In the third quarter of 1982, the Fed abandoned its Monetarist guidelines and adopted moving targets for the growth rates of M1 and M2, adjusting these as they felt necessary. The results were dramatic variations in the growth rate of monetary aggregates as the Fed "leaned against the wind," trying to adjust to changes in the income velocity of money and in economic activity. In spite of rapid increases in M1, M2, and the monetary base, the rate of inflation fell sharply because of the declining income velocity of money—from 13.5 percent in 1980 to 3.2 percent in 1983. From 1983 through 1989, the rate of price inflation averaged 3.6 percent.

The recovery that started at the beginning of 1983 continued to the second quarter of 1990. During that long recovery, the rate of unemployment slowly declined from 9.5 percent to 5.2 percent. Real GNP per capita rose 2.8 percent a year on average. Real federal spending rose only 2.68 percent per year, while under the Carter administration real federal spending had risen 4.44 percent per year and under the Nixon-Ford administrations had risen 3.24 percent per year. The recession, which began in 1990, continued until the second quarter of 1992. Under the administration of President George Bush, the federal budget deficit and the real rate of growth of federal spending both began rising. These events made for a somber transition into the 1990s.

Social Policies

American governments, like all other governments, have always developed and implemented social policies. During the New Deal of the 1930s, the federal government had expanded its policies designed to enhance the welfare and economic security of most individuals as well as more closely monitor business firms and industries. In the 1962-78 period, there was another tumultuous expansion of social policies that differed in scope and nature from previous ones. New laws to protect consumers and the environment were created along with new and expanded regulation of businesses, a phenomenon that Murray Weidenbaum has termed the "new regulation."[39] The "discovery" of poverty in the United States initiated a new range of social policies designed to eliminate it, including an expansion of the security nets for the aged, poor, and disabled. One of these social policies that expanded rapidly to dominate the federal budget and become a continuing source of difficulties was Social Security.

Social Security

The Social Security program began in 1935.[40] The Social Security Act created an Old-Age Insurance (OAI) program as well as the Unemployment Insurance program (UI), the Aid to Families with Dependent Children program (AFDC), and the Old-Age Assistance program (OAA). The initial act intended the program to provide basic income security but not a full income for the retired elderly.[41] And the OAI program was intended to be a fully funded trust fund. However, at the end of the 1930s, Congress wished to begin distributing benefits at an earlier date, so the law was changed to abandon this and implement pay-as-you-go financing.

Later amendments continued to alter the program. In 1950 the benefits of the program were extended to dependents of retired workers and the survivors of deceased workers. The program added a payroll tax for this. In 1965 Congress added disability benefits for workers under 65 and hospital benefits for those over 65. Payroll taxes for these benefits were included, and the program became the OASDHI (Old Age, Survivors, Disability, and Hospital Insurance) program. Though the hospital insurance was funded through the OASDHI program, a medical insurance program to cover physicians' and surgeons' services for those over 65 was separately funded, and the hospital and medical insurance programs together became known as Medicare. The Old-Age Assistance program which had been created in 1935, was instituted to provide income assistance for the needy elderly who otherwise did not qualify. It was initially much larger than OAI and exceeded OAI as late as 1950. In 1972 Congress replaced all of the state-federal OAA programs with a uniform federal Supplemental Security Income program (SSI), which continued to be financed from general revenues and not by the OASDHI taxes.

When Congress established the payroll taxes for the program, half of the tax was to be deducted from the employee's paycheck and the other half was to be paid directly by the employer. Of course, it is clear that the employer's portion of the tax is a labor cost just as wages and salaries are, and if the employer did not pay this portion of the OASDHI, tax it would be paid to the employee.[42] The initial rate was 2 percent—1 percent for the employee and 1 percent for the employer—and this rate continued through 1949. In 1950 the payroll tax rate rose to 3 percent and in 1990 reached 15.3 percent.[43] The maximum income subject to the OASDHI tax was $3,000 from 1937 to 1950 but was gradually raised to over $54,000 by 1990. The original coverage excluded workers in agriculture, domestic service, all governments and nonprofit institutions, railroads, and the self-employed. Coverage was extended until by the 1980s virtually everyone in the economy was covered. The OASDHI rate has remained slightly lower for self-employed workers.

The OASDHI program dominates the federal budget and has been the largest single expenditure since 1973. The revenues from OASDHI payroll taxes have been the most rapidly growing source of revenues for the federal government since the early 1950s and now rank second only to individual income taxes as a federal revenue source. Because of its sheer size and its beginning in the New Deal, the Social Security program has been "the showpiece of America's welfare state."[44] However, the program has some serious flaws and problems.

Though the Social Security program has always been characterized as an insurance program, it is, in fact, a combination of an insurance program and a welfare program.[45] In 1939 Congress began paying out benefits to retirees on a pay-as-you-go basis because it was felt that the early retirees needed the Social Security income even though they had contributed very little to the funds. Douglas Munro calculated that for males who retired in 1940, 97.7 percent of the Social Security benefits they received were a welfare transfer, a figure that had fallen to 66.4 percent by 1971.[46]

A second welfare aspect of Social Security is the progressive method of calculating benefits. A retired worker's benefits are calculated on their average monthly earnings (AME) over their lifetime. Until 1979 monthly benefits were 155.38 percent of the first $110 of the AME, but declined in increments to 21.3 percent of the AME in excess of $1,375. The 1977 changes indexed the AME, but kept the declining pattern. The result is that the "formula is heavily weighted so that those with low earning histories will receive relatively higher benefits for their past taxes than those with high earning histories."[47]

Other characteristics that make Social Security a welfare program include minimum benefits and "benefits for spouses and dependents of beneficiaries who qualify for benefits themselves."[48] Benefits are reduced for those who earn above certain income limits. Finally, a wife is required to forgo her own retirement benefits in order to receive the benefits she is allotted based on her husband's earning record. Widows under 60 years of age are also required to remain single to receive survivor's benefits.

Though the Social Security program is described as having trust funds, there are no true trust funds to generate the regular payments to the beneficiaries. By 1978 the trust funds constituted only 0.8 percent of the unfunded liability of the OASDI program. In fact, the trust funds were only 24 percent of the annual outlays of OASDI in 1980.[49] The 1977 changes were projected to increase the trust funds through 2010 after which they again begin falling to 2028 when they are exhausted. The fact that the Social Security program has always operated on essentially a pay-as-you-go system did not stop the Social Security Administration from describing the program as a true trust fund.[50]

Finally, some economists have argued that Social Security contributions reduce other private savings, and the overall rate of capital formation is thereby reduced. In several studies Martin Feldstein has argued that individuals consider their Social Security contributions to be equivalent to their savings into private pension plans, and the increase in Social Security contributions has led to a decline in private savings and capital formation, an effect called the *asset-substitution effect*.[51] Alicia H. Munnell, among others, has argued that there is a countervailing effect called the *retirement effect*, whereby Social Security induces individuals to retire earlier, leading to higher savings rates.[52] Robert Barro has argued that parents realize that Social Security represents a forced transfer from their children to them, thus reducing the ability of their children to accumulate assets. Parents then increase their savings to leave a larger bequest to their children at their death.[53] Differing estimates of the reduction in private saving arise due to econometric estimation difficulties and differing assumptions. At the present the question of the size of the reduction in private saving and capital formation is still open.[54]

Eliminating Poverty and Welfare

As Charles Murray describes it, through the 1950s there was a general consensus in the United States about the cause of poverty and the purpose of public welfare. "A civilized society does not let its people starve in the streets. It makes a 'decent provision'. . .

for those who would otherwise be destitute."[55] However, there was a fundamental conflict because attempts to aid the "deserving poor"—the involuntarily unemployed and the helpless—would also aid the "undeserving poor"—vagrants and others who could provide for themselves if public welfare were unavailable. And most felt that the provision of public welfare would encourage more people to become part of this latter group. "It was seen as a truism that a welfare system was perpetually in danger of tilting the balance in favor of the easy way out."[56]

Roosevelt's changes to the welfare system in the New Deal were consistent with this attitude. Social Security was *insurance* and forced workers to provide for their old age themselves. Aid to Families with Dependent Children (AFDC) provided welfare payments to widows with children; if they remarried, or when the children became adults, public aid grants ceased. Workmen's Compensation was to assist workers injured during employment and left unable to work, while Unemployment Compensation was a temporary grant to workers who were involuntarily unemployed. "Nothing in the New Deal provided help just because a person was poor or hampered by social disadvantages."[57]

By the late 1950s conditions were developing that would disrupt this general consensus. Welfare seemed to become more permanent, and there was growing resentment at the continued support of what seemed to be healthy adults, particularly the growing AFDC program where most of the women enrolled were not widows as had been anticipated.[58] For many there was also a growing outrage at what were termed the "pervasive injustices" in the American system. In the South there was a growing civil rights movement aimed at bringing about equality of opportunity and treatment between blacks and whites.

By the beginning of the 1960s, there was a discernible change in many attitudes toward poverty and public welfare. An increasing number of people felt that the proper role for the federal government was to create policies that would allow the poor to rise out of poverty, rather than just taking care of them. In a small way this was the first shift toward the view that poverty was structural in nature—in other words, that poverty was caused by the structure of the economic and social system in the United States rather than by the poverty-stricken individual's own behavior. The slogan, "give a hand, not a handout," which became the rallying cry for the War on Poverty, proposed helping individuals escape from the dole. The premise was that most people would work if given an appropriate opportunity, and it was the continuing responsibility of the federal government to help Americans help themselves.[59]

Kennedy's initial programs—the Area Redevelopment Act of 1961 and the Manpower Development and Training Act of 1962—were quite small in size. Under Lyndon Johnson, the War on Poverty quickly expanded. His initial antipoverty bill in 1964, the Economic Opportunity Act, included funding for job training and opportunities through such programs as Jobs Corp, Operation Mainstream, New Careers, Job Opportunities, and the Neighborhood Youth Corps; community antipoverty projects; loans to low-income farmers and small businesses; and the creation of Vista, the domestic version of Kennedy's overseas Peace Corps. In all of the titles of the act, there was a clear "willingness of the federal government to bypass established structures, particularly state and local governments, in order to create the programs needed."[60]

Title VII of the Civil Rights Act of 1964 aided the War on Poverty by forbidding discrimination in hiring, promotion, firing, transfers, training, and pay. To monitor this, it created the Equal Employment Opportunity Commission (EEOC), though it was not given enforcement powers until 1972. From 1964 to 1967, new in-kind transfer programs were created in the form of Medicaid for low-income persons, Medicare for Social Security recipients, and food stamps for low-income persons, while the existing housing programs were expanded. All of these were means tested.[61] Rule liberalization and increasing real benefits were part of the expansions in the AFDC, unemployment insurance, and general welfare programs.

In general, the War on Poverty programs from 1964 to 1967 can be categorized as temporary community action programs and job training programs because it was assumed that as more and better jobs were created and those in poverty obtained better skills, most of the able-bodied poor would obtain jobs and permanently escape poverty. By 1967 it was becoming clear that the War on Poverty was not working. Late in 1967 Lyndon Johnson's principal aide, Joseph Califano, announced that government studies had found that only 1 percent of the persons on welfare were capable of gaining the skills and training necessary to achieve self-sufficiency. As Charles Murray states, "The repudiation of the dream—to end the dole once and for all—was complete."[62]

The structural poverty thesis took on a growing importance. Continued economic growth, it was claimed, would not further reduce poverty because of the way that the economic system distributed income.[63] Radical reforms of the system were required to eliminate or reduce some of the poverty. In other cases Americans would have to accept the long-term assistance of the working poor. Laws began to be passed to enforce equality of result, not just equality of opportunity. Quotas and reverse discrimination often became explicitly or implicitly required to correct past discrimination. And the size of the transfer programs began to grow.

The share of families receiving AFDC payments rose from 1.78 percent in 1960 to 6.57 percent in 1980.[64] The number of disability beneficiaries rose from 687,000 in 1960 to 4,352,000 in 1975.[65] In 1965, the food stamp program had 424,000 participants but 21.1 million in 1980, and by the early 1990s 1 in 11 families received food stamps. The work training programs enrolled 825,000 in 1967 and over 4 million at the peak at the end of the 1970s.[66] Total federal social welfare expenditures rose from 3.07 percent of GNP in 1953 to 5.37 percent in 1965, to 11.15 percent in 1976. If federal expenditures on social insurance and veterans' programs are excluded and only public aid, health and medical programs, education, housing, and other social welfare expenditures included, this rose from 0.82 percent of GNP in 1955 to 1.41 percent in 1965, to 3.33 percent of GNP in 1976.[67]

By 1967 those who pushed the structuralist explanation of poverty were arguing that some form of guaranteed annual income was a necessity if poverty was to be eradicated. Finally Congress approved the most ambitious controlled social science experiment in history, the Negative Income Tax (NIT) experiment.[68] The project began in 1968 and continued until 1978. "The proponents of the NIT in the Johnson administration were out to slay the folk beliefs that welfare makes people shiftless. The NIT, properly designed, would provide work incentives and get people off the welfare rolls."[69]

In each experiment a sample of low-income people was separated into experimental and control groups. Members of the experimental group were told that their incomes would not be allowed to drop below a minimum level (the poverty line) for a specific number of years (three in the first experiments). The control group received no benefits. The experiments began in New Jersey and Pennsylvania between 1968 and 1972, then moved to rural low-income families in Iowa and North Carolina from 1970 to 1972 and an AFDC group in Gary, Indiana from 1971 to 1974. "The largest, longest, and best-evaluated experiments were in Seattle and Denver from 1971 to 1978."[70]

The results tended to confirm the popular wisdom. In all the experiments there was a significant reduction of the work effort. In the Seattle-Denver experiments the NIT led husbands to reduce their work hours by 9 percent and wives by 20 percent. For husbands, the reduction primarily lay in men who opted out of work altogether. The reduction in the work effort by wives was disturbing, because it removed a major source of escape from poverty for many families.[71] There was also a dramatic 43 percent reduction in the work effort for young, single males. Periods of unemployment were significantly longer, and, in the Seattle-Denver experiments, there was a 36 percent increase in the dissolution of marriages.[72]

By almost all measures, poverty was declining from the end of the Second World War through the end of the 1950s. From 1960 to 1969, the number of persons in poverty in the United States fell sharply, then fell much more slowly to 1973, and has risen since 1973. The one group that should have benefited most from the antipoverty programs was people of working age, but in this group poverty declined from 1960 to 1969, remained relatively constant through the late 1970s, and then began rising. Latent poverty, or poverty before all government transfers, fell from 1950 to 1968 but has since been slowly rising.[73] In spite of a dramatic real growth in federal programs and transfers to reduce poverty in the late 1960s and 1970s, the reduction in poverty seems to have stopped the 1970s. Reducing or eliminating poverty in the United States has presented seemingly intractable problems.[74]

Businesses: The New Regulation

The development of programs to eliminate poverty between 1962 and 1978 had their counterparts in the "new regulation of business." Government's economic regulation of business in the United States can be traced back to the founding of the nation, but the regulatory agencies with which we associate most economic regulation began with the creation of the Interstate Commerce Commission (ICC) in 1887. Until 1960 most regulatory agencies were created following the ICC model.[75] These economic regulatory agencies typically focused their activities on the markets, rates, and the obligation to serve of the firms in the regulated industries. Under this model the health of the industry being regulated was a closely related, and frequently major, concern of the regulatory agency.[76]

This close relationship between the regulating agency and the regulated industry was conducive to the development of regulatory "capture" or "collusion," whereby the regulatory commission became a captive of the industry it was supposed to regulate. Murray Weidenbaum suggests that this widely held view had some basis in fact.[77] Concerns about this regulatory capture process and that consumers were worse off with some of this economic regulation contributed to demands for deregulation in the latter part of the 1970s.

Three reasons are generally presented to explain the regulation of businesses: monopolies, inadequate information, and externalities.[78] The new social regulation of businesses was based primarily on the rationales of inadequate information and the externalities created by businesses in providing goods and/or services.[79] There were four major areas of involvement: consumer products, employment conditions, environment, and energy.[80]

Since 1962 there has been a growing array of increasingly stringent regulations to protect consumers. After the Thalidomide scare, Congress amended the Food and Drug Act to require all drugs to be tested for safety and effectiveness before they were released to the public.[81] Growing concern about the effects of cigarette smoking on health led Congress in 1965 to require cigarette manufacturers to add labels to cigarette packages warning of the dangers of smoking. In 1966 Congress moved to ban the sale of hazardous children's toys and articles. In 1966 Congress passed the Traffic Safety Act, which "provides for a national safety program, including setting national safety standards for motor vehicles."[82] In 1967 Congress broadened a 1953 law prohibiting the manufacture, sale, or import of clothing so flammable as to be dangerous when worn by individuals. Consumer finance protection was provided in a series of acts, beginning with the 1968 Truth-in-Lending Act. In 1970 acts were passed to regulate credit bureaus, give customers access to their credit records, prohibit companies from issuing unsolicited credit cards, and protect the customers of securities brokers and dealers. In 1972 an act created the Consumer Products Safety Commission (CPSC) to establish and administer safety standards for all consumer products. In 1974 the Magnuson-Moss Warranty Act established federal standards for written consumer product warranties. In 1977 Congress moved to require warning labels on all products containing the sugar substitute saccharin because some studies suggested that it might be a carcinogen.

Another area of new regulations concerned employee working conditions and terms of employment. In the 1960s laws were passed to provide equal employment opportunities to all applicants and to eliminate sex-based wage differentials. The Civil Rights Act of 1964 established the Equal Employment Opportunity Commission to investigate charges of discrimination in hiring, promotion, firing, transfers, training, and pay. The Age Discrimination in Employment Act of 1967 prohibited job discrimination against individuals aged 40 to 65, and a 1978 act raised the permissible mandatory retirement age from 65 to 70. Affirmative action for the handicapped was instituted in 1973.[83] The most wide-ranging employee regulation came in 1970, with the far reaching Occupational Safety and Health Act, which established the Occupational Safety and Health Administration (OSHA). OSHA was given extensive powers to develop and enforce safety and health standards in the employee workplace.

Environmental regulations have also extensively affected businesses. Following the Air Pollution Control Act of 1962, congress passed laws to control water pollution, require environmental impact statements on construction projects, and control the noise of manufactured products and transportation vehicles. "In more recent years the federal government has also enacted a series of laws emphasizing the development and conservation of energy resources."[84] These laws include the Emergency Petroleum Allocation Act of 1973 and the Federal Energy Administration Act of 1974. In 1977 Congress created the Department of Energy.

The jurisdiction of the economic regulators extended over the specific industry that they regulated, making them responsible for ensuring that their regulations were not so costly as to harm the firms in the industry.[85] The new social regulation of businesses extends over virtually the entire marketplace and they do not have to be concerned with the costs they impose on specific operations.[86] The new regulators become involved in detailed aspects of the firm's production processes often greatly restricting the firm's production choices.[87] Not infrequently, the regulations of different agencies conflict with each other. These characteristics also make it unlikely that any one industry would have an incentive to attempt to capture one of the new social regulatory agencies.

At its peak in the 1970s, the sheer volume of these new social regulations of business was overwhelming. Lilley and Miller report that in the year 1975 alone, 177 proposed new rules appeared, as did 2,865 proposed amendments to existing rules, 309 new final rules, and 7,305 final rule amendments for a total of 10,656 new and proposed rules and amendments, most of which applied to nearly all firms. Between 1970 and 1975, seven new major federal regulatory agencies were created.[88]

The paperwork burden of this regulation is enormous and creates an unintended side effect. The regulatory costs are less than proportional to the size of the firm, penalizing smaller institutions and rewarding bigger ones, potentially leading to more concentrated industries and larger unions.[89] By the 1970s there were rapidly growing complaints from all types of businesses about the escalating burden of paperwork. In 1977 a national commission on paperwork estimated that the burden of regulatory paperwork cost the nation over $100 billion annually—or nearly $500 per capita. Business organizations were filling out an estimated ten billion sheets of paper annually by the end of the 1970s.[90]

In addition to paperwork, the regulations imposed additional costs on firms. In 1976 the Council on Environmental Quality estimated that EPA regulations would cost the economy an extra $40 billion per year by 1984,[91] and in the same year an OSHA-commissioned study found that its own noise regulations under consideration would impose capital costs of $18.5 billion on firms, with billions of dollars more in annual operating costs.[92]

As Murray Weidenbaum says, "Only a Scrooge or misanthrope would quarrel with the intent of the new wave of federal regulation—safer working conditions, better products for the consumer, elimination of discrimination in employment, reduction of environmental pollution, and so forth."[93] The regulations have yielded benefits to consumers, employees, and firms and opened up new opportunities for some. These points are not disputed. What is at issue are the costs of these regulations relative to their benefits.

The critics argue that there is a tendency for the marginal costs of the new social regulation of businesses to exceed the marginal benefits for two reasons. First, because the new agencies do not regulate all of a firm's activities, it becomes harder to measure the benefits of regulation relative to the costs. Second, Lilley and Miller argue that the regulation costs much more than it should and offer the following reasons for this. First, many decisions are reached on the basis of grossly inadequate information. Second, even when information is available, "decisions do not necessarily reflect rational judgment concerning costs and benefits." Regulators may use extreme and unrealistic assumptions to conclude that a regulation's benefits cover its costs. And often little attempt is made to trade off costs and benefits. "Finally, in all too many cases there is strong resistance to considering alternative and sometimes truly innovative approaches."[94] They argue that much of the problem lies with the decision makers at the regulatory agencies because such agencies tend to attract personnel who "believe" in the regulation. "The risk-aversion and security-consciousness of government regulators cause them to try to avoid criticism, which in turn breeds rigidity and inflexibility."[95] Though Lilley and Miller first put forth this argument in 1977, there was little evidence of changes in this situation in the 1980s.

Government And The Economy: A Personal Assessment

This chapter began with a description of the three roles of government, the traditional night watchman's role, reshaping private behavior and redistributing income, and stabilizing economic activity. The first role, based as it is in the Constitution, remains strong in American society. Though there has been some erosion in private property rights, these still remain the firm basis of our free market system. No stronger evidence in support of the importance of private property rights and free markets can be found than the collapse of the centrally planned communist economies of Eastern Europe and the former Soviet Union. Whatever its other flaws, a private property, free-market economy can outproduce any alternative system. And those private property rights also support the democratic societies of the free world.[96]

Many government policies to eliminate poverty—most of which have not worked—require redistributive policies that often conflict with private property rights. The new social regulations on businesses have imposed enormous costs, and it is far from clear that the marginal benefits have exceeded these marginal costs. Many have argued that these new regulations have reduced and often even eliminated productivity growth in the affected industries and that this is a major reason for the slower growth of real incomes and the sharp reduction in the growth of real wages in the 1970s and 1980s.

The federal government's continuing deficits have to be financed by Federal Reserve System purchases or by borrowing through the private credit markets. To the extent that the Federal Reserve System monetizes some of the deficit, the money stock is increased faster, and there is a faster rate of price inflation. But, in the 1980s more of the debt was purchased by the private sector. Overall, this has to divert scarce savings away from productive investment and into federal government spending—spending that does not create additional productive capital. And this has to reduce the real rate of economic growth. Thus, a second reason for the slower rate of economic growth in the late 1970s and 1980s is a relative reduction in the rate of capital formation.

Greater variability in the rate of economic growth has also reappeared with the severe recessions of 1974-75 and 1981-82 and the long recession at the beginning of the 1990s. As a practical matter it has become clear that fiscal policies cannot be used in a discretionary manner to stabilize economic activity. The lags in the recognition of changes in economic activity and in the effective enactment of changes in discretionary spending and taxing policies worsen rather than ameliorate economic fluctuations. And a considerable number of economists doubt whether fiscal policy fundamentally can exert stabilizing influences. Monetary policy has generally been a destabilizing influence for most of the postwar period. In their attempts to lean against the wind in the 1970s, the Fed brought on greater rates of price inflation and destabilized economic activity, resulting in the severe 1981-82 recession. Both Monetarists and Austrians have long argued that because changes in the stock of money have such powerful effects that are unpredictable in their timing, the best policy is to maintain a low, constant rate of growth of the stock of money or, according to the Austrians, to hold the stock of money constant. In this scenario, government, in its fiscal and monetary policies, has been the major source of economic instability in the postwar period.

Few would argue that we do not need governments at the national, state, and local levels. The questions are how large those governments should be and in what activities they should be engaged. If we wish to maximize the welfare of all of our citizens, then clearly governments should only engage in activities for which the marginal benefits exceed the marginal costs. The real question, with which we are still grappling, is how to identify and measure those costs and benefits.

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Notes

1. Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (New York: Oxford University Press, 1987).

2. At both the state and local and, particularly, the federal level, net interest payments to holders of government debt is included. Similarly, transfers to foreigners by the federal government, though small, are also included. Therefore, the government expenditures, excluding transfers to persons, includes more than the direct purchase of goods and services by governments.

3 It should be noted that purchases of government debt by government accounts is something of a shell game. Fundamentally all that is occurring is that rather than increasing federal personal and corporate income taxes, excise taxes, customs duties, and so forth to finance some of the growing federal expenditures, these are being financed by growing social insurance taxes, and the federal securities are substituted for this money in the trust accounts.

4. This discussion of stabilization policies is drawn primarily from the following sources: Anthony S. Campagna, *U.S. National Economic Policy, 1917-1985* (Westport, CT: Praeger, 1987); Robert A. Degen, *The American Monetary System: A Concise Survey of Its Evolution Since 1896* (Lexington, MA: Lexington Books, 1987); Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, NJ: Princeton University Press for the NBER, 1963); Nocolas Spulber, *Managing the American Economy from Roosevelt to Reagan* (Bloomington, IN: Indiana University Press, 1989); Herbert Stein, *The Fiscal Revolution in America* (Chicago: University of Chicago Press, 1969).

5. Campagna, *U.S. National Economic Policy*, 196.

6. Spulber, *Managing the American Economy*, 25. The terms *Keynesian* and *Monetarist* will be used frequently in the following discussion. Refer to Chapter 7 for an explanation of these terms.

7. Richard Gardner, *Sterling-Dollar Diplomacy* (New York: Oxford University Press, 1956), as cited in Jonathan Hughes, *American Economic History*, 3d ed. (Glenview, IL: Scott, Foresman/Little Brown Higher Education, 1990), 524-25.

8. Campagna, *U.S. Economic Policy*, 196.

9. Campagna, *U.S. Economic Policy*, 198, 210.

10. Stein, *The Fiscal Revolution in America*, chapter 9.

11. Ibid., 241.

12. Friedman and Schwartz, *A Monetary History of the United States*, 625.

13. See Stein *The Fiscal Revolution in America*, 241-80.

14. Friedman and Schwartz, *A Monetary History of the United States*, 625.

15. Stein, *The Fiscal Revolution in America*, 281.

16. Degen, *The American Monetary System*, 122. The comprehensive examination of monetary policy in the 1950s is Daniel S. Ahearn, *Federal Reserve Policy Reappraised, 1951-1959* (New York: Columbia University Press, 1963).

17. Stein, *The Fiscal Revolution in America*, 452-53.

18. Ibid., 137-38.

19. Ibid., 143.

20. Campagna, *U.S. Economic Policy*, 345.

21. Degen, *The American Monetary System*, 152-53.

22. Campagna, *U.S. National Economic Policy*, 362.

23. Ibid., 362.

24. Campagna, *U.S. Economic Policy*, 375-76; Hugh Rockoff, *Drastic Measures: A History of Wage and Price Controls in the United States* (New York: Cambridge University Press, 1984), 210-12.

25. Robert J. Gordon, "The Response of Wages and Prices to the First Two Years of Controls," *Brookings Papers on Economic Activity* 3 (1973): 777-78, as cited in Campagna, *U.S. Economic Policy*, 379-80.

26. Rockoff, *Drastic Measures*, 233.

27. Degen, *The American Monetary System*, 159.

28. Ibid., 160-61.

29. Alan Blinder estimates that most of the spending that arose from the rebates and tax reductions occurred in 1976, not 1975, so that there was no fiscal stimulus until the recovery was well underway. (Alan Blinder, *Economic Activity and the Great Stagflation* (New York: Academic Press, 1979), 164-65, as cited in Campagna, *U.S. National Economic Policy*, 401.)

30. Because the federal government had to enter the credit market to borrow the funds to reduce and rebate taxes to consumers, the stimulus arising from the additional spending due to the rebates would only offset the reduced spending due to the crowding out of borrowers in the credit markets as interest rates rose to reallocate funds from private market borrowers to the federal government.

31. Degen, *The American Monetary System*, 162.

32. Ibid., 163-64.

33. The Kemp-Roth tax cut bill of 1977 proposed substantial cuts in federal income tax rates. In 1978 the Steiger-Hansen tax bill sought to roll back capital gains taxes from the then 49.1 percent rate to the pre-1969 rate of 25 percent. In June of 1978, California voters approved Proposition 13, the Jarvis-Gann Initiative, to roll back California property taxes and limit future increases; within a few years Massachusetts voters approved a similar type of property tax initiative. For a discussion of these, see the papers in Sections 2, 4, and 5 in Arthur B. Laffer and Jan P. Seymour, eds., *The Economics of the Tax Revolt* (New York: Harcourt Brace Jovanovich, 1979).

34. On "Reaganomics," see Bruce T. Bartlett, *Reagonomics: Supply-Side Economics in Action* (Westport, CT: Arlington House, 1981); and Bruce W. Kimzey, *Reaganomics* (St. Paul, MN: West Publishing Co., 1983).

35 In 1982 the Reagan administration retreated somewhat with the Tax Equity and Fiscal Responsibility Act.

36. Because personal exemptions were eliminated for higher income taxpayers, there was a range of taxable incomes where the marginal income tax rate was effectively 33 percent.

37. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982.

38. Degen, *The American Monetary System*, 191-92.

39. Murray L. Weidenbaum, *Business, Government, and the Public*, 2d ed. (Englewood Cliffs, NJ: Prentice-Hall, 1981), chapter 2.

40. Most of the following discussion is drawn from Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: The Cato Institute, 1980). A shorter version can be found in Peter J. Ferrara, *Social Security: Averting the Crisis* (San Francisco: The Cato Institute Studies in Domestic Issues, 1982).

41. Ferrara discusses this in some detail in *Social Security*, 17-27.

42. The Social Security Administration has continued to confuse this by claiming that the employee pays only one half the tax while the employer pays the other, implying that the employee's contribution to the social security programs is only one half of the amount actually paid. This is, of course, nonsense. The worker bears directly and indirectly the entire OASDHI payroll tax.

43. In each of these cases, the direct employee payroll tax rate is one half of the total rate.

44. Ferrara, *Social Security: The Inherent Contradiction*, 3.

45. Ibid., 53-60.

46. Douglas Munro, "Welfare Component and Labor Supply Effects of OASDHI Retirement Benefits," (Ph.D. diss., Ohio State University, 1976), as cited in Ferrara, *Social Security: The Inherent Contradiction*, 55.

47. The 1977 amendments indexed average monthly earnings (AIME) and changed the primary insurance amount formula to 90 percent of the first $180 of the AIME, 32 percent of the next $905 of the AIME, and 15 percent of the rest. Ferrara, *Social Security: The Inherent Contradiction*, 55.

48. Ibid., 56.

49. Ibid., appendix tables 20-21.

50. The Social Security Administration has consistently used false and misleading statements to misrepresent the program to the public in an effort to gain general support. Prior to 1965 their publications stated that Americans contributed to special trust funds and benefits were paid *from* those segregated trust funds when the worker retired, died, or was disabled. This, of course, was an outright lie, and intense criticism caused the SSA to alter the statement so that this was implied but not actually stated. The Social Security Administration's misinformation campaign has, however, led many workers to believe that their OASDHI contributions are being accumulated in a trust fund that they can draw on at retirement or in the event of disability. In a 1960 Supreme Court decision that upheld the SSA's elimination of benefits to the wife of a deported communist who had long paid Social Security taxes, an outraged Justice Hugo Black railed at the SSA's misinformation campaign. (See *Your Social Security*, HEW Publication, N. (SSA) 76-10035, June, 1976, as cited in Ferrara, *Social Security: The Inherent Contradiction*, 66. The SSA's misleading assertions are discussed in detail in Ferrara, 66-74.)

51. See the following papers by Martin Feldstein: "Toward a Reform of Social Security," *The Public Interest* (Summer 1975), and "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September-October 1974): 905-26.

52. See the following studies by Alicia H. Munnell: *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977), "The Impact of Social Security on Personal Savings," *National Tax Journal* 27 (December 1974): 553-67, and *The Economics of Private Pensions* (Washington, D.C.: The Brookings Institution, 1982).

53. See Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy* 82 (November/December 1974): 1095-1117, and *The Impact of Social Security on Private Savings* (Washington, D.C.: American Enterprise Institute, 1977).

54. For example, see Nicholas Barr, "Economic Theory and the Welfare State: A Survey and Interpretation," *Journal of Economic Literature* 30 (June 1992): 741-803.

55. Charles Murray, *Losing Ground: American Social Policy, 1950-1980* (New York: Basic Books, Inc., 1984), 16. Most of this section draws upon Murray's seminal study. Murray suggests that the roots of this can be traced to the Poor Laws of Elizabethan England.

56. Ibid., 16.

57. Ibid., 17.

58. Though the illegitimacy rate had risen from 4.5 percent to 5.3 percent, or by 17.8 percentage points, between 1955 and 1960, this was still far lower than it was later to become. (Ibid., pp. 18-19.) Murray discusses this in some detail, especially the largely unjustified focus on black families on AFDC.

59. The publication of Michael Harrington's *The Other America* in 1962 is often credited with igniting the War on Poverty and was widely read by members of the Kennedy and the Johnson administrations, though, of course, other forces were simultaneously at work. (Michael Harrington, *The Other America* (New York: Macmillan, 1962); other influential works were Richard Cloward and Lloyd Ohlin, *Delinquency and Opportunity* (Glencoe, IL: Free Press, 1960); and Dwight MacDonald, "Our Invisible Poor," *The New Yorker*, 19 January, 1963.]

60. Marc L. Miringoff and Sandara Opdycke, *American Social Welfare Policy: Reassessment and Reform* (Englewood Cliffs, NJ: Prentice-Hall, 1986), 62.

61. "Means tested" indicates that to be eligible, individuals or families had to fall below a threshold income (or sometimes asset) level.

62. Murray, *Losing Ground*, 40.

63. Women heading households with small children, the unskilled, and those discriminated against because of race, age, sex, or religion would not share in the fruits of economic growth.

64. Ibid., 244.

65. Ibid., 47.

66. Ibid., 48.

67. Ibid., 242-43.

68. With a negative income tax, if a person's income drops below a specified level (typically the poverty level) the government pays the person enough (i.e., *negative* taxes) to bring his/her income up to the specified level. Only when the person's income rises above the specified level does (s)he begin paying taxes into the government rather than receiving taxes.

69. Ibid., 150.

70. Ibid.

71. Ibid., 151.

72. These results certainly understate the magnitude of the effects. (Ibid., 153.) On the origins of the NIT see Hugh Heclo and Martin Rein, "Social Science and Negative Income Taxation," in Suzanne Berger, ed., *The Utilisation of the Social Sciences in Policy-Making in the United States* (Paris: OECD, 1980); and Martin Anderson, *Welfare: The Political Economy of Welfare Reform in the United States* (Stanford, CA: Hoover Institution Press, 1978). The fall 1980 issue of the *Journal of Human Resources* was devoted entirely to the NIT results. Also see: David Kershaw and Jerilyn Fair, *The New Jersey Income-Maintenance Experiment*, Institute for Research on Poverty Monograph Series, vol. 1 (New York: Academic Press, 1976); and Robert A. Moffit, "The Negative Income Tax: Would It Discourage Work?" *Monthly Labor Review* 104 (April 1981): 23-27.

73. These data are taken from Murray, *Losing Ground*, chapters 4-10.

74. There is a continuing debate about the reasons for this. In his seminal book, *Losing Ground*, Charles Murray attributed these distressing results to the unintended negative consequences of good intentions. He contended that federal policy makers of the 1960s and 1970s did not take into account three essentially correct premises of the popular wisdom: People do respond to incentives and disincentives (or, the carrot and the stick *do* work); people are not inherently hard working or moral; and people must be held responsible for their actions. (Murray, *Losing Ground*, p. 146.) His book provoked a vigorous response. See Robert Royal, "Charles Murray and his Critics," in Michael Cromartie, ed., *Gaining Ground: New Approaches to Poverty and Dependency*, Ethics and Public Policy Essay no. 60, (Washington, D.C.: Ethics and Public Policy Center, August 1985), 25.

75. Weidenbaum, *Business, Government and the Public*, 20.

76. Weidenbaum, *Business, Government, and the Public*, 16. This section draws upon Weidenbaum and the following two studies: William Lilley III and James C. Miller III, "The New 'Social' Regulation," *The Public Interest* 47 (Spring 1977): 49-61; Peter Asch, *Consumer Safety Regulation: Putting a Price on Life and Limb* (New York: Oxford University Press, 1988).

77. Weidenbaum, *Business, Government, and the Public*, 17.

78. Ibid., 12-14.

79. In *Consumer Safety Regulation*, chapter 3, Peter Asch extensively discusses the inadequate consumer information rationale for consumer safety regulation.

80. Forty-six major consumer safety and business regulation laws were passed between 1962 and 1978. These are listed in tables in the following two books. Murray L. Weidenbaum, *Business, Government, and the Public*, 2d ed. (Englewood Cliffs, NJ: Prentice-Hall, 1981), table 1-1, pp. 8-10; and, Peter Asch, *Consumer Safety Regulation: Putting a Price on Life and Limb* (New York: Oxford University Press, 1988), table 1.2, p. 6.

81. In the early 1960s a new sedative, Thalidomide, came on the market. It soon became clear that women who used Thalidomide while pregnant were likely to give birth to children with deformities, and the drug was withdrawn from the market. The belief that this would not have occurred if Thalidomide had been more extensively tested prior to marketing, brought about the amendments to the Food and Drug Act.

82. Weidenbaum, *Business, Government, and the Public*, 7.

83. The Americans with Disabilities Act, which went into effect in the middle of 1992, outlawed discrimination against the handicapped and also greatly expanded the definition of handicapped status.

84. Weidenbaum, *Business, Government, and the Public*, 10-11.

85. Ibid., 18.

86. Ibid., 19-20.

87. Lilley and Miller, "The New 'Social' Regulation," 53.

88. Lilley and Miller, "The New Social Regulation," 51.

89. Ibid.

90. Weidenbaum, *Business, Government, and the Public*, 198.

91. Council on Environmental Quality, *Environmental Quality: Seventh Annual Report* (Washington, D.C.: U.S. Government Printing Office, 1976), 145, as cited in Lilley and Miller, "The New 'Social' Regulation," 51.

92. Bolt, Beranek and Newman, Inc., *Economic Impact Analysis of Proposed Noise Control Regulations* (Washington, D.C.: OSHA, 1976), as cited in Lilley and Miller, "The New 'Social' Regulations," 51.

93. Weidenbaum, *Business, Government, and the Public*, 21.

94. Lilley and Miller, "The New 'Social' Regulation," 56.

95. Ibid., 59.

96. Some, in fact, argue that economic freedom and political freedom are essentially inseparable.