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Explain Reaganomics and access it success as a policy tool.

With the election of Ronald Reagan in 1981 the greatest economy in the world faced a defining point. Following the presidency of James Carter the economy of the USA was struggling with consequences for the entire world and Ronald Reagan was handed the task of steering the economy back onto the path of prosperity that had been seen in the decades before. The importance of what Reagan had to ‘play with’ cannot be underestimated as the world economy is very dependant on how the US economy performs. As the saying goes, “If the America sneezes the rest of the world catches a cold”. Reagan now faced a key decision as to what path he should take either keeping the economy steady or going for a whole new revolutionary set of economic policies. He chose the path of more revolutionary policies and as a result we see the birth of what has come to be known as ‘Reaganomics’.

The economic theory that is known as Reaganomics when first implemented was touted as not just based on economics but was economics with moral foundations. The economic policy that Reagan decided to follow can be described more easily with two simple economic terms. These being his policy were based on ‘Extreme Keynesian economic theory’ and were largely ‘supply-Side policies’. Reagan firmly believed that the reason that the American economy was struggling, when he came to power, was because of excessive taxation. In order to strengthen the economy Reagan followed a number of key policy areas and based his first six months in office purely trying to sort the economy out.

Reaganomics followed a ‘Laisser faire’ attitude towards the economy as he believed that intervention and regulation by the government were harmful to the economy. Reagan therefore followed a policy of what he saw as deregulation allowing companies to make their own economic decisions without the government interfering. This policy of deregulation was based on a few major points. The main being the belief that a decrease in taxation would give businesses more money and could therefore afford to produce more, requiring an increase in workers and consequently leading to a surplus in money that gave people in general more money to spend, save and invest, all of which leads to a healthy economy. "Lower taxes would spur business to invest, and send Americans rushing to stores to spend."[1] With the American people spending more then companies would employ more and so the trend goes on. This way he saw that he could not only increase the incomes of the average American person, but reduce unemployment rates therefore reducing benefits payments and increasing tax revenues.

Reagan believed that tax revenue could be increased whilst adopting a policy of lower taxation by adopting the theory of the Laffer curve. This was another supply side economic policy by which you could stimulate the economy and increase production levels which would in turn lower output therefore meaning that more people would be paying income tax thus increasing tax revenue. This is once again a non interventionist theory by creating a situation where businesses can conduct themselves without excessive government intervention or regulation. In line with these policies two major pieces of tax legislation were passed. Firstly in 1981 we see ERTA which reduce individual marginal tax rates by 25% over three years. This basically reduced an individuals level of taxation and reduced the taxes on the lower and middle classes more, in percentage terms, than it did from the rich. We also see the tax reform act of 1986, which raised corporate income taxation and reduced personal tax liabilities. He believed both of these policies would significantly increase tax revenues and give the economy the boost it needed.

This policy of tax cuts led directly to another supply side policy in which he believed. It was continuously argued that those who earned more could afford to pay the taxes in order to help those who were not as well off, however Reagan did not believe in this and instead believed in an economic theory known as the 'Trickle Down effect'. He was of the opinion that if taxes were lower for the rich in the economy then investment would increase therefore increasing these rich people even further. Where his views differed from others was as to whether this would help those poorer of just simply

[1] Ronald Reagan

increase the poverty gap that was between them. Under the trickle down theory the benefits of the increased incomes of the rich would 'trickle down' and benefit all Americans, even the poorest of them, in such ways as new earning potential with the creation of more employment due to increases in production.

These beliefs that were central to the economic theory of Reaganomics were not shared by all economist and many cases as to whether they would not work or not. The policy of deregulation was widely criticised as it was believed that it would only work in the short run. Economists said that in the short run there would be greater competition in the markets and therefore lower prices but in the long run, if industries went unregulated there would be a rise in corruption and mismanagement. If industry was left unregulated then fraud would increase and we could see the creation of huge monopolies emerging which could then have the power to control an industry, which the government did not want. Reagan however was aware of this possible pitfall and therefore introduced some legislation that would stop this. The main piece of legislation we see created as a way of stopping possible fraud or mismanagement was the 'Office of Information and Regulatory Affairs' which sought to guarantee that any deregulation followed cost benefit principles and therefore remove any chance of businesses abusing the deregulation policies pursued. As well as scepticism about deregulation many also held fears that other problems would arise due to the economic policy followed. Many did not believe that tax revenues could not increased by lowering general taxation and felt that public services and the poor would suffer at the hands of Reaganomics. It was widely believed that it was unfair to follow a policy of borrowing money and racking up huge debts in order to give the wealthy a tax break.

In order to access whether these policy tools were effective we have to look at how the economy performed during the years of Reaganomics and discuss both the pro's and con's of its implementation. There are many examples of how Reaganomics are seen to both failed and succeeded.

One of the biggest criticisms people have of Reaganomics was the debt that it got the US into. In 1981 when Carter leaves office the US is in $994 billion debt and when Reagan leaves office in 1989 the US was then in $2,867 billion in debt. This is nearly a three percent rise in debt coming from large spending in defence as a deterrent against possible aggressive forces as well as funding the tax cuts he implemented. This is a huge rise and therefore is a clear argument against the success of Reaganomics as a policy tool.

In response to this claim three main arguments are made against it the first being the very necessary military build up needed due to the cold war. As well as this the spending on military did at no time exceed the amounts spent during the 70's. The second argument is that throughout the policy of tax reduction at no time did tax revenue decrease yet instead we can see a progressive increase in revenue. The third argument against the claims of Reaganomics causing huge debts is that if you look at it as a percentage of GDP or GNP the figure is not that bad.

One argument put forward to demonstrate the success of Reaganomics is the fact that between 1978 and 1981 the top level of capital gains tax was cut from 35% down to 20%, yet instead of the loss many expected in tax revenue by 1985 they had reached levels 90% higher in real terms. This is a huge increase in revenue and goes someway to justifying the tax cuts in Reaganomics. To further lament this case when in 1986 the capital gains tax was increased their revenues fell by 20% by 1990.

However there are arguments as to why these figures are not accurate or fair. The first is the fact that when these are implemented it is at the beginning of the recession, which is argued to be more responsible for the change. Secondly these figures are said to not be accurate due to peoples reaction to the news capital gains taxes were imminent. People responded by selling their assets until the tax cut was implemented which distorts the figures.

Another major argument as to why Reaganomics succeeded as a policy tool is the economic growth that it achieved. During the era of Reaganomics the average annual growth rate of real gross domestic product was 3.2% a year. This level was much better than in other periods, for example from 1989 to 1995 it stood at only 2.1% a year. This demonstrates a huge increase and by the end of the Reaganomics era the American economy was one third larger than when it began.

The argument against this theory is very simple and claims that the policies of Reagan would have done little or nothing. The claim is simply that the growth took place as part of the business cycle and the changes Reagan made, particularly income tax changes, which are most commonly attributed to this growth, did little or nothing to actually affect growth rates.

Many other arguments back up both cases and go some way to prove the effectiveness of Reaganomics but the ones highlighted above are the main cases. However we cannot discount these smaller arguments.

Other arguments that say Reaganomics was not an effective policy tool all are valuable arguments that cannot be ignored. During the era of Reaganomics the US trade deficit quadrupled meaning that America during the tenure of Reagan began to import a lot more produce than they exported suggesting the economy is not quite as healthy as we are led to believe. Another important argument is that the number of people below the poverty line increased year upon year during Reaganomics with 31.8 million under the poverty line in 1981 and by 1992 there were 39.3 beneath it. This demonstrates a key belief of Reaganomics is false and not as moral as it claims to be suggesting that the rich were getting richer whilst the poor were getting poorer.

Many further arguments also exist demonstrating the benefits of following Reaganomic policy. A large policy associated with Reaganomics was the reduction of the unemployment rate. When Reagan took office in 1981 the rate of unemployment stood at 7.6% yet by the time his reign finished it had fallen to a rate of 5.5%. This is a significant fall and benefited all of the economy. Under Reaganomics over eight million new jobs were created.

Private and personal wealth was also better by Reaganomics with significant rises. In real terms the average family's incomes grew by $4,000 and when Reagan left power the level of people's income fell by around $1,500. This proves to some extent that the tax cuts benefited all rather than just the rich with people not only earning more due to higher levels of production but there also being more employment available therefore allowing the average persons quality of life to improve.

Other important benefits to Reaganomics include the fact that during the ear of Reaganomics interest rates fell by around 6 points encouraging spending, which further went to help the economy grow and a fall in inflation from 12.5% to 4.4% when he left office. As for the argument that under Reaganomics public services suffered due to tax cuts spending under Reagan increased by a massive 19.7%.

As to whether Reaganomics were a successful policy tool or not, I believe they were successful. Whilst the case for saying that they were not successful is strong in my opinion the case saying policy was successful is far more compelling. Facts and figures such as fall in unemployment rates, economic growth, rises in income and all other arguments above are largely unquestionable. Not only did Reaganomics achieve the results it did expanding the American economy but it achieve it whilst suffering a recession not of its own making. The recession in 1981-2 was a by-product of the economic policies of James Carter and Reaganomic policy managed not only to survive the recession but come back a lot stronger.

However I do not believe that it can be claimed that Reaganomics was solely to thank for the improvement of the economy (which in my opinion was improved to pre Reagan) as many circumstances went to increase the impact of the policies. Even the recession went some way to exaggerate the impact of Reaganomics with it leading to some distorted facts or figures.

Had Reagan not come to power and not introduce Reaganomics to the success it achieved I do not believe that the American economy would be in as strong as a position as it is in today. Whilst Reaganomics can be blamed for some economic downfall I believe that the use of Reaganomics as a policy tool was largely successful.

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