

January 17, 1983

## **REAGANOMICS: MAKING GAINS**

### **INTRODUCTION**

Stay the course, urges Ronald Reagan. But so did the captain of the Titanic, retort critics of the White House. Are the implicit fears of such critics justified? Is Reagan steering the American economic ship of state to safe harbor or smack into icebergs? Navigators would have a hard time reading the economic currents. On the one hand, a dramatic economic upturn might be signaled by the spectacular advance of the stock market, the decline in interest rates, and the dampening of inflation. On the other hand, unemployment remains high and the economy bobbles along in a trough.

Yet inside the tangled web of often confusing economic statistics, some key signs are unmistakable. During the first two years of Reagan's term of office, fundamental changes have taken place in the economy, which may have laid the foundations for a long period of growth and prosperity. The personal savings rate, for instance, is up nearly 30 percent from its 1981 low. The stock market is at a ten-year high. The venture capital industry has hit record heights. All this occurred in a year marked by a severe business recession. The surge of new capital has spawned a near record crop of new business incorporations, especially in "high tech" firms, and a healthy number of new public stock offerings. Inflation is at a ten-year low and interest rates have been cut by one-third since Reagan took office. Such achievements profoundly affect consumers, businesses, and government.

Even the dispiritingly high unemployment rate must be seen in perspective. Reduction in unemployment has always lagged behind economic recovery--especially when the economy is also undergoing profound changes. In addition, comparisons of today's rate with that of earlier periods are dangerous. In the first

place, unemployment insurance, welfare payments, and other factors have increased the "basic" unemployment rate but reduced the plight of the unemployed. According to one Department of Labor survey, the average unemployed family can still count on an annual income of approximately \$19,000.<sup>1</sup>

Moreover, we should remember that the unemployment rate is the proportion of the active labor force which is seeking work, without success. It is not an indicator of the percentage of the adult population not working. So we can have periods where the unemployment rate is high while the percentage of the adult population at work is also high. Today, when more than 56 percent of the adult population is employed (the "employment ratio"), is such a period. This is about the same as in 1969, when the economy was booming and the unemployment rate was 3.5 percent, and actually higher than in 1953, when unemployment was at its lowest since World War II. It means that a very high proportion of families still have at least one breadwinner. In 1933, by comparison, the employment ratio was only 44 percent.

This does not mean, of course, that the laid-off auto worker in Detroit should feel cheerful. But it does mean that Congress should not misunderstand the unemployment problem and stampede into "action" that will undermine the key structural changes that are under way.

Lower taxes and lower inflation mean that once again economic conditions favor the saver over the debtor. Americans now have the incentive to cut their expenditures and work off their debts. Indeed, consumer installment debt has declined steadily throughout the recession from a high of 14.8 times personal income in early 1980 to 12.85 in September 1982.<sup>2</sup> This means that consumers are coming out of this recession with a lightened debt burden. It offers hope for a sustained recovery--in past recessions, consumers usually have plunged deeper into debt. Now, as Forbes magazine reports, we "have come through the 1982 recession with credit accounts in the best shape since early 1974."<sup>3</sup> Consumer credit defaults among New York banks are the lowest since the pre-1975 recession month of June 1974. Forbes notes that "Consumers have had the capacity to buy throughout the 1982 recession; they are simply showing restraint." This restraint is replenishing the capital coffers needed to finance investment and modernization.

Thanks to fading inflation, households and businesses are shifting their resources from the popular inflation hedges of the

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<sup>1</sup> For a full analysis of the factors contributing to the unemployment rate, see Peter Germanis, "Unemployment: What's to Blame?" Heritage Foundation Background No. 222, October 22, 1982.

<sup>2</sup> Business Conditions Digest, U.S. Department of Commerce, Bureau of Economic Analysis, November 1982, p. 73.

<sup>3</sup> Priscilla Meyer, "An Old Game with New Rules," Forbes, October 11, 1982, p. 238.

1970s into productive assets, like stocks and bonds. For the real estate industry, the major inflation hedge of the middle class, 1982 was the hardest year since the 1969-1970 housing slump. Some of real estate's luster will undoubtedly be restored in the recovery. But the boom days of 10 to 20 percent growth may be gone as resources flow into nonhousing production. During the inflationary seventies, it made sense to put money into housing. The median home price soared from \$23,000 in 1970 to \$62,200 in 1980, a 170 percent increase.<sup>4</sup> The Dow Jones Industrial Average, in comparison, increased by only 18 percent over the same period, not enough to keep pace with the 112 percent surge in the consumer price index.

According to the National Association of Realtors, home prices, after adjusting for inflation and concessionary financing, actually fell at least 10 percent in the past year.<sup>5</sup> Home Loan Bank Board Chairman Richard Pratt predicts that fewer Americans will buy houses in the 1980s than in the 1970s, primarily because they may not need "the hedge against inflation."<sup>6</sup> Viewed in this way, softness in the housing market is a positive, not negative, sign. Housing industry sluggishness is evidence of the success against inflation.

Other inflation hedges and tax dodges have taken similar nose dives under Reagan. Diamonds, antiques, and leisure goods are all in the doldrums. Sotheby Park Bernet, the nation's largest antique auction house, last year suffered its first loss since World War II. The diamond market is near collapse. A one carat D-flawless white gem, a benchmark jewel, reached a peak of \$64,000 in 1979-1980, but had plunged to \$21,000 by the beginning of December 1982.

Bad news for inflation hedges, however, heralds good news for the financial markets. In a recent study, Claremont economist John Rutledge finds that reductions in inflation have in past periods powerfully stimulated new capital formation. Extrapolating historical trends, Rutledge estimates that "each percentage point drop in the inflation rate should send \$100 billion of the tangible assets that people hold back into the financial market as increased capital supplies."<sup>7</sup> With inflation expected to stabilize at about 6 percent, the country soon should be awash with new risk capital. "We'll see an increase in credit supplies

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<sup>4</sup> Existing Home Sales 1981, Economics and Research Division, National Association of Realtors, Washington, D.C., 1982.

<sup>5</sup> Dr. Jack Carlson, chief economist and executive vice-president of the National Association of Realtors, NEWS, National Association of Realtors, September 27, 1982.

<sup>6</sup> Bob Fick, "Need for House as Hedge Against Inflation Foreseen Declining," Washington Post, September 25, 1982.

<sup>7</sup> John Rutledge, "Why Interest Rates Will Fall in 1982," The Wall Street Journal, December 14, 1981.

of \$400 to \$500 billion," continued Rutledge. This translates into even lower interest rates and expanded savings and investment -- just what the supply siders promised all along.

In short, Reaganomics works. In the thirteen months since it was redirected, the nation's rudder has been set firmly in place. The policies are paying off in a new crop of business enterprises, expanded savings, and reduced inflation. But the economy, like an ocean liner, changes course only in degrees. Economic turnarounds are measured in years, not months. The important progress made so far, however, vindicates the supply-side approach and should encourage the Administration to stay a course of lower money growth, tax reduction, and a freer marketplace.

### THE ATTACK ON INFLATION

Reaganomics is not a scheme to redistribute wealth from one group to another, but one to benefit all Americans, particularly the poor, by inducing rapid and sustained economic growth. A rising economy, Reagan often points out, pulls everyone up with it. Inflation and high taxes, however, tilt economic incentives in favor of consumption, debt, and leisure, thereby undermining the nation's productive capacity. Reagan's economic policy is designed to restore capital-producing incentives so that the economy once again generates the jobs and wealth necessary to raise the standard of living of all Americans.

The President was convinced that a glut of newly printed money had stoked the inflationary fires that blazed in the seventies. He urged the Federal Reserve, the independent body charged with regulating the nation's money supply, to slowly but steadily reduce the money supply so that inflation could be dampened. Accordingly, from a high of 8.3 percent money growth (M1) in 1978, the Fed nearly cut off the money spigot in the first seven months of 1982. The inflation rate correspondingly fell from 13.3 percent in 1979, a postwar high, to below 5 percent by the end of 1982.

But the Fed also has allowed the money supply to fluctuate erratically. From November 1981 to January 13, 1982, the money supply increased at the dangerous annual rate of 25 percent. Then from January to August, the Fed apparently grew alarmed that it might reignite inflation, slammed on the monetary brakes, and reversed direction. The money supply grew by only a 2 percent annual rate. In the last thirteen weeks, the Fed has been reversing course again and the money supply appears to be surging ahead at a 16.7 percent annual rate. The recent increase pushes up annual money supply growth this year to 8 percent, far above the Fed's target of 2.5 to 5.5 percent.

If not corrected, it threatens to set off inflation, destabilize economic activity, exacerbate unemployment, and sap the Fed's credibility.

Lower money growth brings with it the short-term side effects of lower output and employment. According to some studies, it may take eighteen months for these side effects to be overtaken by reduced inflation and sound economic growth. In the past, administrations have reacted to the upswing in unemployment by stoking the fire of inflation through easy money and government programs. There have been four bouts with inflation in the last fifteen years; each was lost because political and economic leaders did not have the courage to see the anti-inflation fight through to the finish. After each failure, unemployment rose above previous peaks, economic growth often fell below previous troughs, and inflation bounced off a higher plateau.

Each monetary fix has been but a temporary palliative. Ever larger doses are required to pack the same stimulative wallop, bringing with it higher inflation and eventually higher unemployment. Historical and international evidence clearly shows that there is no long-term trade-off between inflation and unemployment. The question is: Can the President withstand the political pressure to "do something" about unemployment? Can he resist the loose money seduction and persevere until recovery begins? In the last fifteen years, no president has had enough courage and confidence to resist these pressures.

Reagan has vowed, that he will continue to attack high unemployment by getting at its root, high inflation, and riding out the inevitable withdrawal symptoms. Cutting inflation and keeping it down is still the key to breaking the inflation-recession cycle. The current withdrawal symptoms are the price paid for the many mistakes of the past. If the course against inflation is maintained, the U.S. will soon enjoy -- for the first time in fifteen years -- a recovery untarnished by a new burst of inflation.

## CLEAR SIGNS OF SUCCESS

The underlying benefits of this course and the confidence it engenders are becoming clear. There are convincing signs of a dramatic expansion of the capital pool, an increase in risk taking, and a surge of investment in productive ventures.

### 1. The Stock Market Surge

The fortunes of the stock market ebb and flow each day. A soaring stock market is traditionally a precursor of economic recovery. And for good reasons. Rising stock prices open a rich source of business capital, increase household wealth, and generate profits for pension plans, insurance funds, and other institutions that include substantial holdings of stock in their portfolios.

At present, the stock market has surged to its highest level in ten years. The Dow Jones Industrial Average at the end of

1982 stood around 1,000, almost 25 percent higher than the average in June. The rise in prices has added perhaps \$120 billion to the wealth of American households, according to Allan Sinai of Data Resources, Inc. A study released by the Congress's Joint Economic Committee (JEC), estimates that if the Dow Jones Industrial Average reaches 1,150, the increase in per capita wealth will be \$875. Sixty percent of this is in the form of direct increases in household wealth, with 40 percent indirect, through the holdings of private and public pension funds.<sup>8</sup> "And the most significant development," explains Committee Vice-Chairman Roger Jepsen, "is that 46 percent of that wealth increase is going to families with incomes of less than \$25,000 per year."<sup>9</sup> A rough rule of thumb, according to the report, is that "every 10 percent rise in stock prices over their August 1982 low, adds \$175 to per capita wealth holdings."

The recent stock market rally is especially good news to public and private pension funds with substantial stock holdings. Private pension funds have 40 percent of their assets in stocks. "The recent 30 percent rise in the price of corporate equities," reported Dr. Lowell Gallaway, author of the Joint Economic Committee study, "translates, roughly, into a twelve percent increase in the assets of private pension programs."<sup>10</sup> Public pension plans hold less stock, but the recent stock rally also significantly enhances their assets. "Thus, the recent 'bull market' may have provided a six percent increase in the value of assets supporting public retirement systems," adds Gallaway. In all, those dependent on public and private pension systems have had their wealth increased by perhaps an additional \$85 billion --nearly \$400 per capita -- due to the recent stock rally.

By exerting such a powerful effect on household wealth, stock market rallies usually play a significant role in fueling economic expansion. The Joint Economic Committee study discovered that stock price increases encourage households to shift the composition of their wealth away from tangible assets to more liquid financial assets. Both factors, the study concludes, will stimulate consumption and saving simultaneously.

But will the bull market continue? And what is the reason for the upsurge in stock and bond prices? Many economists argue that success in the fight against inflation has buoyed business prospects and made it easier for investors to estimate future business profits. Stanford University economist John Shoven, for example, argues in Business Week that "The market has been held

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<sup>8</sup> Dr. Lowell E. Gallaway, "Economic Impact of the 1982 Bull Market," a staff study prepared for the use of the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee (JEC), Congress of the U.S., October 25, 1982, p. 9.

<sup>9</sup> JEC, Press Release, November 5, 1982.

<sup>10</sup> Gallaway, "Economic Impact," p. 12.

down by a bubble of negative expectations. But as you get out of that bubble the market really could explode."<sup>11</sup>

MIT economist Franco Modigliani concurs that disinflation is a tonic for stock market prices. "The moment that the expectations of inflation stop rising, stock prices must start to rise,"<sup>12</sup> argues Modigliani. How high can the stock market go? If stocks were only valued at replacement cost of assets the stock market could still shoot up by another 600 points in the Dow, according to Boston College's John Ciccolo.<sup>13</sup>

## 2. A Revival of Initial Public Offerings

The equity markets have recently bloomed with new financing for smaller, more risky firms and businesses making their first public offerings. In light of the lingering recession, the new issues market in 1982 is surprisingly buoyant. New public offerings for 1982 are estimated at \$1.2 billion, using the Initial Public Offering Reporter figures for the first eleven months of 1982. This would make the 1982 total about the same as 1980, and far above most years in the capital starved seventies.

Many experts think that after ten years of stagnation, the stock market is becoming a fertile source of new business risk capital. New public offerings in 1981 reached a record high of \$3.2 billion, a total of 448 new initial public stock sales. That was a whopping 130 percent increase over the robust 1980 dollar figure and more than 60 times larger than the depressed 1974 total.<sup>14</sup> This comeback stems from two major public policy changes: the capital gains tax cuts of 1978 and 1981 and lower monetary growth.

Experts blame the 1976 capital gains tax hike (from 24 percent to a maximum 49 percent) for choking new public stock financing to a trickle.<sup>15</sup> This scarcity of new stock financing reverberated throughout the economy and contributed to lowered investment, innovation, and productivity.

The more favorable tax treatment for new stock issues since the 1978 capital gains tax cut, however, has caused the number and dollar amount of initial offerings to come roaring back.

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<sup>11</sup> Business Week, September 27, 1982, pp. 56-57.

<sup>12</sup> Ibid.

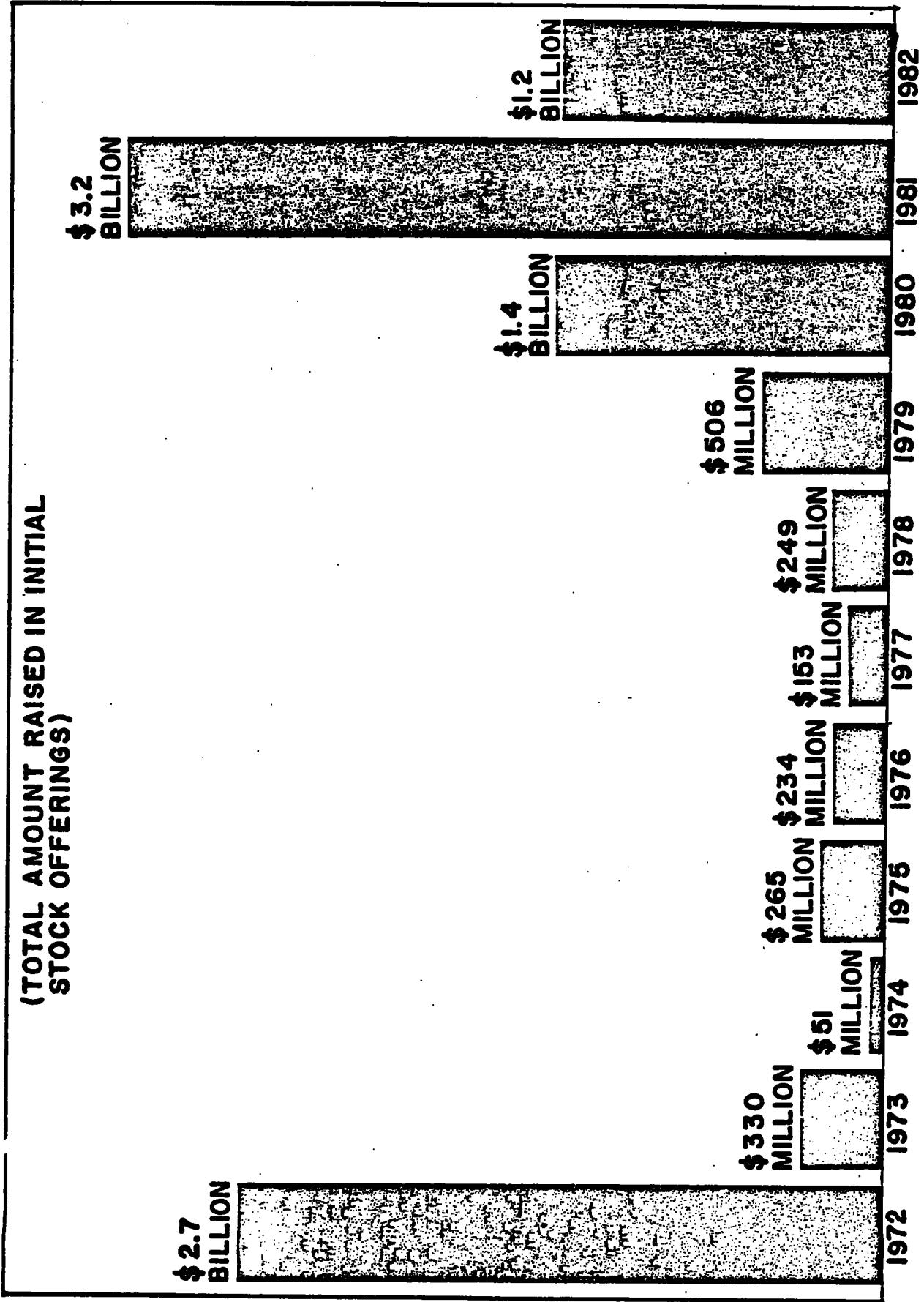
<sup>13</sup> Ibid.

<sup>14</sup> Kevin Farrell, Venture magazine, April 1982, pp. 29-33. See also Venture, October 1982, p. 86.

<sup>15</sup> Ibid. See Also Peter J. Ferrara, Economic and Investment Observations, "Capital Gains: A Painless Tax Cut," H.C. Wainwright & Company Economics, Boston, Massachusetts, July 6, 1981, See also "Government-Industry Cooperation Can Enhance the Venture Capital Process," General Accounting Office, AFMD-82-35: (Washington, D.C., 1982).

# INITIAL PUBLIC OFFERINGS

(TOTAL AMOUNT RAISED IN INITIAL STOCK OFFERINGS)



SOURCE: IPO REPORTER



Stanley Pratt, editor of Venture Capital Journal, is bullish: "Since the end of 1977", he explains, "we have seen an increased strengthening of demand in the marketplace for the offerings of smaller companies going public for the first time." Such offerings are not for every company, cautions Pratt, but "Public financing has become a viable alternative for the well-managed smaller company exhibiting an above average growth rate and having the prospect for continued growth over the years ahead."<sup>16</sup>

### 3. Business Starts at a Near Record

Entrepreneurship is the key to a dynamic, growing economy. Entrepreneurs are the creative thrust behind invention, factory starts, and new jobs. Their risky initiatives jolt businesses from complacency, undermine calcified business practices, and infuse the marketplace with competitive verve. High levels of entrepreneurial activity in high tech firms have brought prosperity to areas such as Houston, and Boston's beltway.

Small businesses generate most of America's new jobs. David Birch and Susan McCracken, of the MIT Center on Neighborhood and Regional Change, estimate that two-thirds of the new jobs were generated by businesses with fewer than 20 employees, and about 80 percent by firms with 100 or fewer employees.<sup>17</sup>

Studies show that small businesses are also more innovative than large corporations and contribute the bulk of the nation's output. According to Capital Publishing, "Small business accounts for 55 percent of all private employment, 48 percent of the nation's business output, 43 percent of the GNP, and more than 50 percent of all industrial inventions and innovations."<sup>18</sup> The Reagan economic program aims, in large part, to stimulate entrepreneurial activity. The cuts in capital gains tax, personal income tax rates, and inheritance taxes have altered the incentives for risk taking and personal savings. Saving is especially vital for small business. As a survey by The National Federation of Independent Business discovered, almost 70 percent of new firms use personal savings as their major source of capital.<sup>19</sup>

Despite the recession's severity, 1981 marked an all-time record for new business incorporations. Nearly 600,000 new busi-

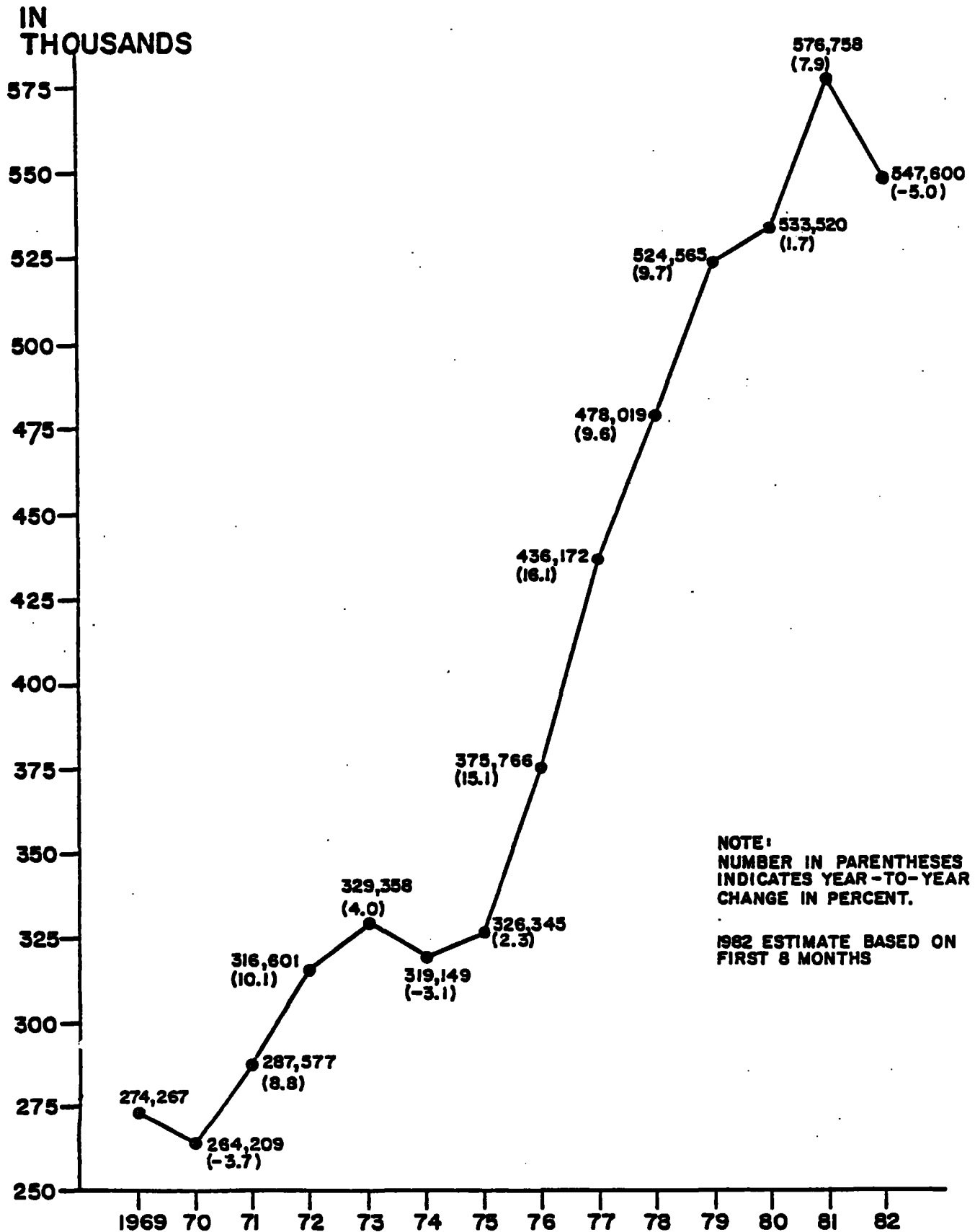
<sup>16</sup> Stanley E. Pratt et al., How to Raise Venture Capital (New York: Scribner, 1982), p. 197.

<sup>17</sup> David Birch, "Who Creates Jobs?", The Public Interest, No. 65, (Fall 1981).

<sup>18</sup> The Venture Capital Industry--A Brief Overview (Wellesley Hills, Massachusetts: Capital Publishing Corporation, 1982), p. 64.

<sup>19</sup> Jonathan A. Scott, Assistant Professor of Finance, Southern Methodist University, statement before the Subcommittee on Tax, Access to Equity Capital and Business Opportunity of the House Small Business Committee, Washington, D.C., May 20, 1982.

# NEW BUSINESS CORPORATIONS



SOURCE: DUNN AND BRADSTREET,  
"MONTHLY NEW"

nesses applied for corporate status, twice the number of ten years ago. New business incorporations have held up surprisingly well in 1982. During the first eight months, Dun and Bradstreet reports that the pace of new activity is only 5 percent off last year's record.<sup>20</sup> During recessions, according to Birch, new business incorporations swell, as unemployed workers seek new opportunities in entrepreneurship.

The gloom felt by many over the state of the economy overlooks the emergence of this huge, new generation of job-creating firms. Observers also tend to ignore the important change taking place in the structure of industry. It is true that the manufacturing sector has receded sharply over the last decade and the current business recession is no doubt hastening that decline. But today only 13 percent of the workforce is employed in manufacturing. Sixty percent either produce or process information. The overwhelming number of new jobs have come from the vibrant service sector. The manufacturing sector, which has actually lost jobs, began its decline long before Reagan took office.<sup>21</sup>

But what about business failures? Business bankruptcies, indeed, swelled to their highest level since the Great Depression. The failure rate, according to Dun and Bradstreet, exceeded 80 per 10,000, the highest rate since 1933.<sup>22</sup> These figures, however, do not portend disaster. Many businesses, it is true, have failed because high interest rates have squeezed profits and a declining economy has shrunk their markets. But much of the current high failure rate simply reflects the recent bumper crop of new businesses. Record numbers of new business starts create record numbers of business failures. Small and young firms always have high failure rates. Studies show that one-third of all new businesses fail within one year, and about 50 percent fail within two years.<sup>23</sup>

Business failures, not surprisingly, are greater in growing areas like Houston than in declining regions. In his study of 5.6 million businesses in the U.S., MIT's Birch discovered that "The more dynamic the local economy (e.g., Houston) the greater proportion of firms that fail. Our most successful areas are

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<sup>20</sup> David E. Gumpert, "Business Start-Ups Are at a Near-Record High," The Wall Street Journal, September 27, 1982. See also The State of Small Business: A Report of the President, U.S. Small Business Administration, Washington, D.C., March 1982.

<sup>21</sup> Tom Richman, "Peering into Tomorrow," Inc. Magazine, October 1982, pp. 45-48.

<sup>22</sup> Edward I. Altman, Professor of Finance, Chairman MBA Program, New York University, before the Subcommittee on General Oversight of the Committee on Small Business, U.S. House of Representatives, June 23, 1982.

<sup>23</sup> "Business Failures, Business Turnover Rates, and Bankruptcies," Economic Memo, U.S. Small Business Administration, Economic Research Division, August 13, 1982.

those with the highest rates of innovation and failure, not the lowest."<sup>24</sup> Business failure, often read as a sign of economic decline, at this time is a necessary side effect of innovation and economic growth.

#### 4. Best Year for Venture Capital

The booming venture capital industry is another indication that the economy is experiencing healthy structural change. Venture capital firms specialize in funding the fast growing high tech businesses that are on the cutting edge of the economy. They are injecting much needed risk capital in an otherwise anemic economy. Venture capital investments, as recorded by Venture Economics, a respected research firm, rose to a record of \$1.4 billion in 1981, from less than one-third that amount five years earlier. 1982 is expected to set another record. Private venture capital partnerships raised 65 percent more funds in the first half of 1982 than in the first half of 1981--more than \$700 million compared with \$867 million in all of 1981 and \$661 million in 1980.

The venture capital industry began to improve in 1978 after the capital gains tax was reduced from 49 to a 28 percent maximum. In June 1982, the industry had estimated committed funds of \$6.6 billion -- more than twice the level of only five years ago and an increase of \$4 billion since 1977. Critical to the industry's rapid expansion was the additional cut in capital gains taxes from 28 to 20 percent enacted as part of the 1981 Reagan tax package.<sup>25</sup>

Some venture backed firms, tiny only a few years ago, are now giants, employing thousands of workers. Brent Rider, Chairman of NASBIC, the National Association of Small Business Investment Companies, explains that there is a close connection between the venture capital industry and the lead sellers of the economy. "Almost every new business in high tech fields during the past 20 years," says Rider, "including Teledyne, Apple Computer, Atari, Intel, American Microsystems, and Data General--received backing from one or more venture companies."<sup>26</sup>

A recent study by NASBIC reveals the importance of venture capital to job creation. According to the study, firms backed by venture capital "generated more than 10 times the employment growth of all small business, 11 times the growth in sales and assets, and six times the increase in federal tax payments."<sup>27</sup>

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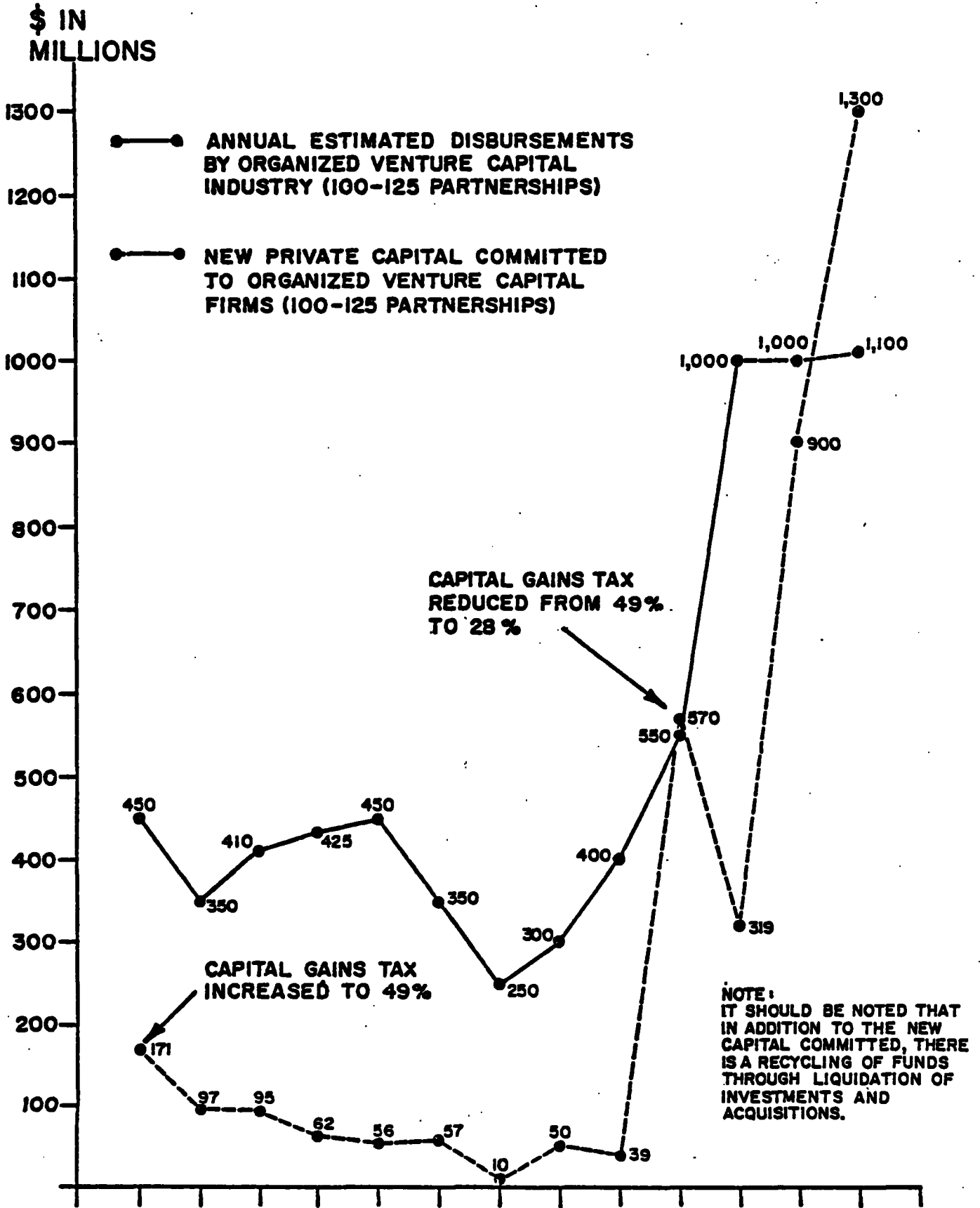
<sup>24</sup> Birch, op. cit.

<sup>25</sup> The State of Small Business, op. cit., p. 146.

<sup>26</sup> Brent T. Rider, Statement before the Subcommittee on International Trade, Finance, and Security Economics, of the Joint Economic Committee, September 30, 1982.

<sup>27</sup> Willis Witter, "Venture Capital Seen Solution," The Washington Times, October 1, 1982.

# VENTURE CAPITAL INDUSTRY FUNDING & DISBURSEMENTS



SOURCE: DEVELOPED BY GAO FROM DATA PROVIDED BY VENTURE ECONOMICS.

The stimulus to venture capital and risk taking provided by the Administration's 1981 tax measure has changed the economic landscape fundamentally. Stanley Pratt calls the reemergence of entrepreneurship "the most remarkable social development of the late 1970s." He writes: "Colleges today are bursting with young entrepreneurship driven by the apparent availability of funds and they are creating more opportunities than ever before, as each successful funding stimulates other attempts."<sup>28</sup>

##### 5. The New Incentive to Save

One of the most important consequences of the 1981 tax reduction and the moderation in inflation has been the increase in the savings rate. Once again, Americans are investing in their nation's economic future.

Reagan long ago stressed the need for the United States to boost its savings rate. A larger pool of savings, he argued, helps fuel increased capital spending in plant and equipment--the mainspring of improving standards of living. And, as noted earlier, personal savings also play a crucial role in financing new business ventures.

Japan's high savings rate is widely credited with fueling that country's prosperity. Japan saves 19.4 percent of its disposable income, compared to America's 6 to 7 percent level. Japan has created powerful incentives for savings by its tax structure and its tight lid on inflation. Japan does not tax capital gains accruing to individuals; the U.S. taxes capital gains at rates up to 20 percent. Japan's corporate income, personal income, and dividends are also taxed at substantially lower rates than they are in the United States. Overall, Japan took 24.1 percent of its GNP in taxes in 1978, compared to the U.S. government's share at all levels of 30.2 percent of GNP.<sup>29</sup> Just as important, Japan has kept inflation below 4 to 5 percent for most of its recent history. Japan's low 3 percent inflation this year, creates an attractive climate for savings.

Though the Japanese deficit is far larger than the American as a proportion of GNP, it is far less harmful to its economy. The Japanese government can dip into the ample Japanese savings pool to finance the proportionally larger deficit. In Japan, at least, budget deficits do not automatically translate into high interest rates and inflation. A high rate of savings can offset the government's borrowing needs.

The Administration's economic strategy has centered on reducing the two principal barriers to savings: high inflation

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<sup>28</sup> Pratt, op. cit., p. 14.

<sup>29</sup> "Federal Tax Policy Memo" (Washington, D.C.: Tax Foundation, May, 8, 1981.)

and high tax rates. Both factors have lowered the return on each dollar saved. The Administration's package of lower marginal taxes, tax deferred savings plans, and slower money growth has begun to reward savers. After personal savings reached a low of 5.4 percent in January of 1981, it climbed to nearly 7 percent in October 1982--the highest rate since 1976.<sup>30</sup> The rates typically fluctuate widely. November's rate dropped to 5.8 percent, but the trend is unmistakably upward. This improvement is occurring even before the final 10 percent tax rate reduction planned for next July. With disposable personal income now over \$2.2 trillion, every percentage point increase in the savings rate adds about \$22 billion to the pool of savings. The savings rate is now about 2 percentage points higher than that of the last five years. If this level continues, the stock of savings will be about \$44 billion higher next year.

This savings expansion is manifest in various ways. Money market funds have surged a stunning 300 percent in the last 21 months, largely in response to financial deregulation. In just the first nine months of 1982, the funds grew at an annualized rate of 25 percent to a total of \$180 billion.<sup>31</sup> IRAs and Keogh plans, which allow tax delayed accumulation of savings for retirement, attracted more than \$15 billion in new money between February and November 1982.

FUNDS FOR IRA AND KEOGHS  
(in billions)

	<u>Commercial Banks</u>	<u>Mutual Savings Banks</u>	<u>Savings &amp; Banks</u>	<u>Credit Unions</u>	<u>Total</u>
February 6, 1982	\$10.074	\$4.885	\$14.456	\$.353	\$29.768
November 1982	\$17.3	\$6.2	\$20.5*	\$.943**	\$44.94

\*Estimated from October figures of no ceiling accounts and March figures of ceiling accounts.

\*\*Estimated from July figures.

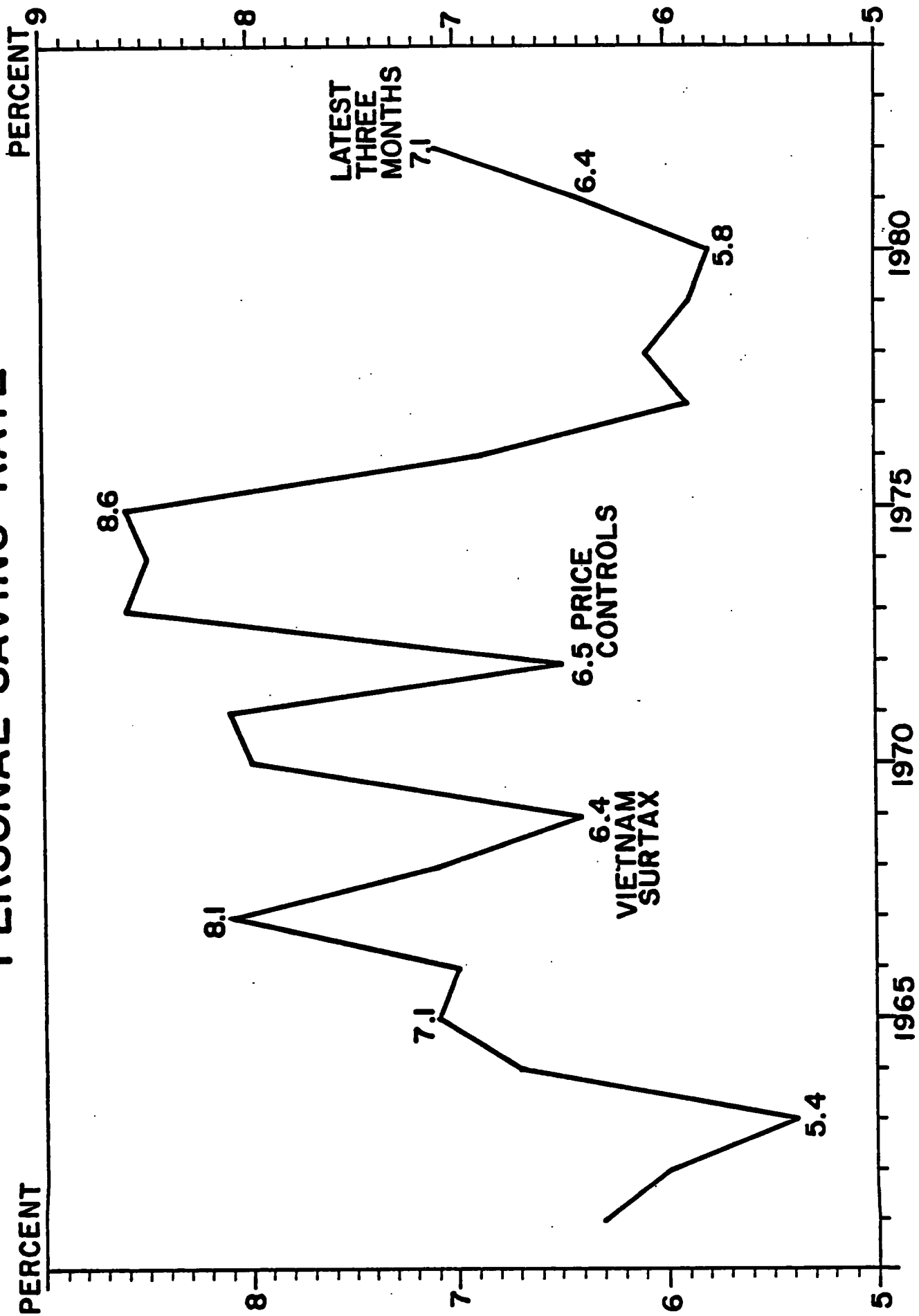
Source: Federal Reserve Board

The upsurge really began in early 1982 when the right to participate in these plans was extended to more than 116 million Americans. By November, millions of Americans had invested an estimated \$40 billion in IRA and Keogh accounts at banks, savings and loan associations, credit unions, mutual savings banks, investment companies, and other financial institutions. This pool of funds is more than 50 percent larger than ten months

<sup>30</sup> Business Conditions Digest, op. cit.

<sup>31</sup> Ibid.

# PERSONAL SAVING RATE





earlier and is expected to swell substantially more. If the trend continues, more than \$25 billion in new money will flow to these retirement accounts as the April 15th tax deadline approaches. These funds are providing Americans with not only a high return investment toward a more secure retirement, but also the capital for new investment and entrepreneurship that will give the economy a much needed boost.

This spectacular performance refutes the contention that savings does not respond to tax incentives. Indeed, the evidence clearly suggests that the keystone of the supply-side philosophy -- that savings and investment have been repressed by the tax structure -- is substantially correct. The American public saved less than the Japanese or Germans not because we were less thrifty or virtuous, but because the U.S. tax and business climate was more hostile to savings than in these more prosperous countries. The U.S. public has responded to lower tax rates exactly as supply siders promised -- by reducing consumption expenditures and stashing more into savings accounts.

## 6. Interest Rates

The success in taming inflation is also paying off in a dramatic reduction in interest rates. Over the past year, rates have dropped substantially, relaxing their choking grip on businessmen, investors, and consumers and setting the stage for economic recovery. The prime interest rate, for example, fell from 20 1/2 percent in August 1981 to the December 1982 figure of 11 1/2 -- a 40 percent improvement since Reagan assumed office. Corporate bond rates also have decreased from 16.97 percent in September 1981 to around 12.5 percent at the end of 1982.<sup>32</sup> As a result, the heavy interest burden on businesses will be substantially lightened.

Small and marginal firms without access to the long-term debt markets were particularly vulnerable and many were squeezed into bankruptcy as interest rates soared. The average nonfinancial corporation in 1981 paid 40 cents in interest charges for every dollar of income, up sharply from 20 cents for every dollar of income in 1978.<sup>33</sup> Businesses that have held on, however, are taking advantage of the improved interest rates to refinance their short-term debt. Larger businesses that can float their own bonds are rushing to beef up balance sheets by refinancing their high-cost, short-term debt with the now lower-cost, long-term debt. As a result, corporate America looks stronger today than even six months ago. Balance sheets are blacker, cash flows are healthier, and income reports are brighter.

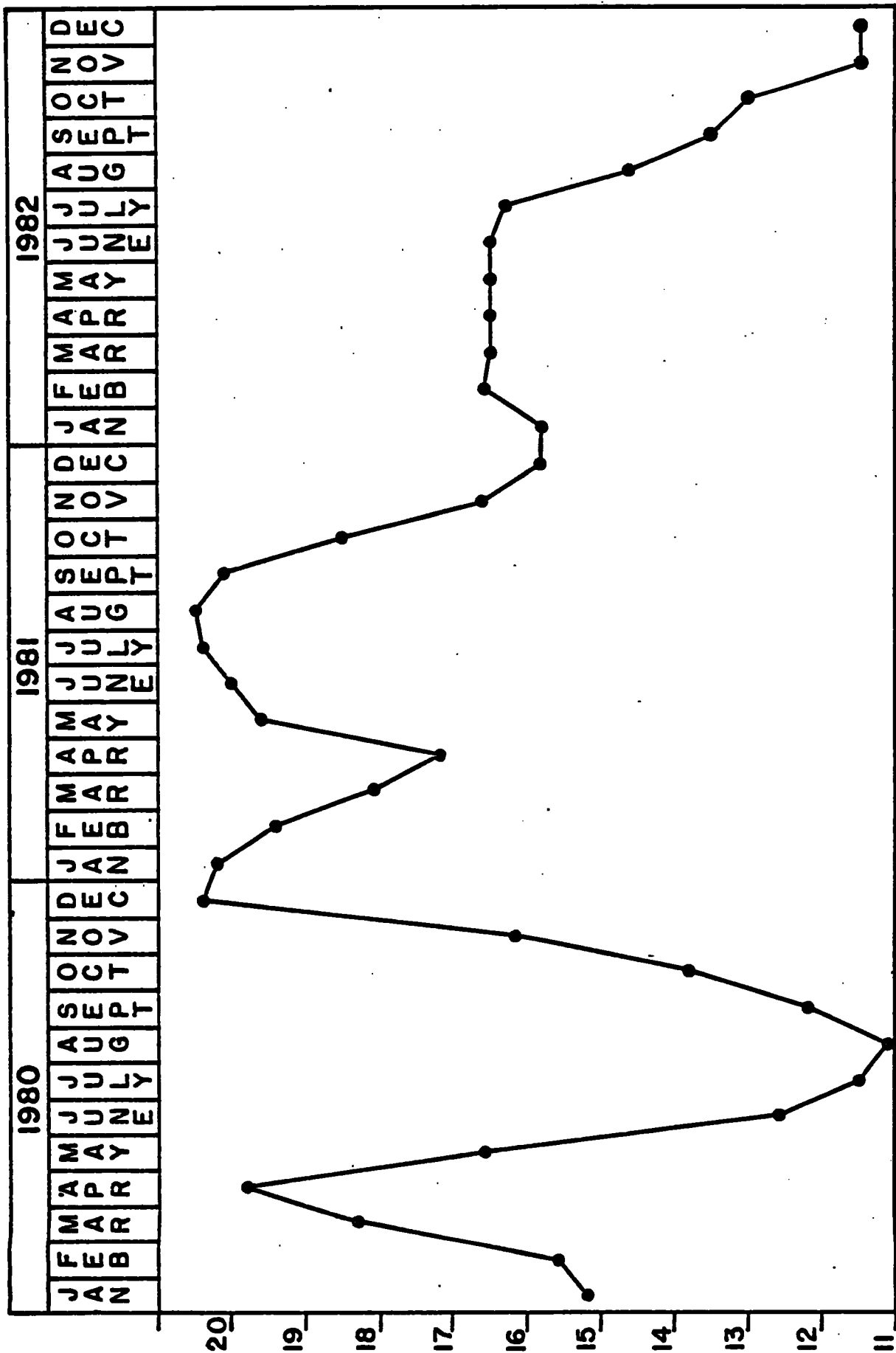
Lower interest rates are a boon to the government as well. Treasury continually must refinance over one trillion dollars of

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<sup>32</sup> Ibid.

<sup>33</sup> Altman, op. cit.

# AVERAGE PRIME RATE CHARGED BY BANKS



SOURCE: BUSINESS COND. DIGEST

national debt as well as pay for burgeoning future deficits. The Treasury bill rate has dropped from a high of 16.3 percent in May to around 8 percent at the end of 1982, sharply cutting the Treasury's cost of servicing the debt. Every one percent drop in the T-bill rate, reports the Congressional Budget Office, will cut the budget deficit over the next 3 years by over \$15 billion.

Consumers, too, benefit from interest rate reductions. Everything consumers buy on credit, from cars to houses to household appliances, becomes substantially cheaper when interest rates decline. Mortgage rates, for one, have dropped from a high of 18 1/2 percent in September 1981 to around 13 percent in December 1982. This reduces average homebuyer's mortgage costs by several thousand dollars.

## CONCLUSION

The Administration's success in containing inflation and cutting tax rates has begun to pay rich economic dividends that soon could propel the economy to long-term growth and prosperity. One of the most promising trends is the recent surge of new capital. Personal savings, which provides most small businesses with initial seed capital, is at a five-year high. Venture capital, the source of new risk capital for high-growth and technologically advanced companies, is expected to reach a record this year. The stock market, a major source of capital for medium-and-larger-sized businesses, is at a ten-year high. Initial public stock offerings are at a surprisingly healthy level for a recessionary period. Other hints of a stronger economy are interest rates down by one-third and the inflation rate cut in half since Ronald Reagan took office. The U.S. dollar soared against major European and Japanese currencies, signaling the confidence abroad in the U.S. economy. The G.N.P., too, has had positive, if timid, increases over the second and third quarters of 1982.

These successes lead to a number of important implications:

a) The supply siders are essentially correct-- marginal tax cuts stimulate savings rather than excess demand. Contrary to much critical speculation, as the tax rates were cut 15 percent over the last two years, inflation fell by half.

b) Firm monetary policy is essential to reducing inflation.

c) Reducing inflation is the key to economic health--to savings, low interest rates, and an expansion in employment.

d) Reductions in unemployment always lag behind economic recovery. There is no long-term trade-off, however, between inflation and unemployment.

e) Cutting inflation is rarely painless. Weaning an economy from an inflationary binge is like drying out an alcoholic. The

withdrawal symptoms can be severe, but they are the unavoidable price of recovery.

f) Deficits are not a major factor in causing high interest rates or inflation. Today's projected budget deficits are more than eight times higher than in the Administration's March 1981 forecast, yet interest rates have been cut by more than one-third and inflation by half.

g) The chances for an inflation free recovery have been enhanced by the shift of household wealth out of tangible assets such as housing into financial assets such as stocks and bonds.

These signal important directions for the new Congress:

1. The third year of the tax rate reduction scheduled for July 1983, together with the indexation of tax brackets for inflation, is essential to preserving and strengthening the incentives for saving and capital formation. Congress should accelerate both indexing and the 10 percent rate cut to January 1983.

2. Economic recovery must not be sabotaged by further tax hikes. No matter which euphemism is used -- "revenue enhancements," "loophole closings," "compliance measures," or "user fees" -- any measure that generates additional revenue to the government reduces available capital for business investment.

3. The Federal Reserve Board must regain control of the money supply. The current acceleration in money growth, if continued, will rekindle inflation, possibly throwing the economy back into recession and sabotaging the entire Reagan economic program. Congress should consider monetary reforms to ensure that the Fed pursues a policy of low and stable money growth.

4. Congress should reduce taxes further on savings, dividends, and capital gains to create jobs through greater capital investment rather than through make-work "jobs" bills. A good start would be to index capital gains for inflation and eliminate penalties for early withdrawal of money from IRA and Keogh accounts. These actions would move the tax system to a consumption based tax that encourages savings and investment.

5. The President should support additional marginal income tax rate reductions, perhaps to a top rate of 20 percent. This would bring much of the underground economy to the (taxable) surface, expand the tax base, unleash new savings and investment activity, and make deductions, exemptions, and most loopholes much less worthwhile.

6. There is need for further budget cuts and reforms to reduce the expanding public sector, which consumed a record 24 percent of the nation's GNP in 1982. Reduced government spending would free additional resources for business investment, entrepreneurship, and ultimately more jobs.

7. Congress must formulate a long-term solution for social security's underlying financial and structural problems. Social security's unfunded liabilities, now larger than the national debt and growing, hang like a dark cloud over the economy. The prospect of huge new social security taxes to finance the deficit demoralizes the younger generation and threatens to undermine economic growth by coopting new capital sources.

This agenda builds on the Administration's first year strategy. In the second year, the legislative debates were monopolized by the economic philosophy that prosperity is induced by taxing more and spending more. This philosophy has not worked in the past 50 years and it never will. At the beginning of its third and perhaps its most important legislative year, the Reagan Administration should return to the bold colors of its first year's program. It is clear from the changes taking place in the American economy that Reaganomics is working. In 1983, the program must be defended and expanded.

Thomas M. Humbert  
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