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FISCAL POLICY CHANGE: LESSONS FROM THE REAGAN ERA

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President-elect Trump and his team are contemplating the most significant changes in fiscal policy since the Reagan presidency. Proposed changes in taxation, spending and regulation all follow the major fiscal initiatives enacted in the early 1980s. Of course, we don't yet know which fiscal changes will make it into law—or how successful they'll be. But we can compare the fiscal initiatives and economic environment of the Reagan era with today's policy wish list and economic conditions. And this may help assess the economic and investment implications of proposed fiscal change.

The Reagan-Era Fiscal Initiatives

The crown jewel of Ronald Reagan's fiscal policy initiatives was the Economic Recovery Tax Act of 1981 (*Display 1, next page*). This legislation ushered in what was described then as the "biggest tax cut in history." It lowered the top marginal tax rate by 23% over three years; and in the process, the top individual tax rate dropped from 70% to 50%. In addition, the individual tax code was indexed to inflation and new incentives were created to bolster individual savings. On the corporate side of the tax code, the 1981 tax cut introduced the Accelerated Cost Recovery System (ACRS), which allowed a faster depreciation of property for tax purposes.

Equally important were Reagan's budget initiatives that authorized a major increase in defense spending. He also made major changes in a number of entitlement programs, although they're often overlooked or forgotten today. Along with the changes in entitlement programs, Reagan received congressional support for the creation of the National Commission on Social Security Reform, whose major recommendations were passed with bipartisan support in Congress in 1983.

The final piece of Reagan's fiscal initiatives was a major push toward either deregulation or regulation reform for a number of industries. The industry list included energy, finance, healthcare, railroads, telecommunication, trucking and airlines.

Trump's Fiscal Wish List

At the moment, Trump's proposed fiscal initiatives appear quite similar to Reagan's in basic structure. Trump's plan calls for a reduction in marginal tax rates for individuals, but it goes further than Reagan's by also including a rate cut for businesses. And to make these tax-code revisions more economically efficient, Trump's plan seeks to eliminate a long list of deductions and exclusions. The proposed tax changes wouldn't provide an equal offset between rates and deductions for everyone. But while the plan would create a "less friendly" tax environment for some, the end result would be a smaller tax bill for a larger group of people and businesses.

Like Reagan, President-elect Trump wants to increase defense spending. Yet the scale of the defense buildup hasn't been unveiled. It's worth noting that defense spending today accounts for only 3.9% of gross domestic product (GDP), which is near the postwar low. By contrast, when Reagan took office in 1981, defense spending's share was 6.3%—and it increased to 7.7% five years later.

Concerning infrastructure spending, Trump campaigned on promises of major investments in public and private infrastructure. The scale and funding for this fiscal initiative are still unclear, but it, too, mimics Reagan's initiatives—although Reagan achieved his infrastructure spending through changes in the tax code (i.e., the ACRS).

On the regulatory front, the immediate focus of the Trump administration will likely be on healthcare, finance and energy. But we wouldn't be surprised to see that list grow over the president's four-year term.

Reagan-Era Recession Before Recovery

The vast sweep of the Reagan fiscal initiatives was designed to accomplish many things: eliminate the tax code's inflation-driven upward creep in the brackets for individual taxpayers; provide tax relief; increase incentives for savings and investment; reduce the size of the federal government; rebuild US military capabilities; improve the competitive

Display 1
US Fiscal Policy: Trump's Proposals vs. Reagan's Policy Changes

Policy	Trump	Reagan		
Taxation	• Reduction in marginal tax rates	• 23% cut in marginal rates over 3 years (1981–1983)		
	• Tax carried interest as ordinary income	• Accelerated Cost Recovery System (ACRS)		
	• 20% tax on ½ of dividends and capital gains	• Capital gains tax reduced to 20%		
	• Repeal estate tax	• Reduced estate taxes		
Spending	• Defense? 3.9% share of GDP	• Defense ➔ boosted share of GDP from 6.3% to 7.5%		
	• Infrastructure? Private or Public	• Infrastructure ➔ ACRS boosted construction sector		
Deregulation	Healthcare	Healthcare	Railroads	Airlines
	Finance	Finance	Telecommunications	
	Energy	Energy	Trucking	

	Economic Backdrop	
Inflation (Core)	2.2% current run rate	11% in 1981 and dropped to 4% in 1983
Federal Funds	0.375%	Peaked at 19% in 1981 and ended 1983 at 9.5%
10-Year Treasury	2.35%	Peaked at 15% in 1981 and ended 1983 at 11.65%
Jobless Rate	4.9% average for 2016	Averaged 7.6% in 1981 and 9.6% in 1983

As of November 29, 2016
Source: AB, Congressional Budget Office, Haver Analytics and Tax Foundation

environment for businesses; and promote growth by scaling back or eliminating a number of government regulations.

To be fair, the Reagan initiatives were deployed in an unsettled and adverse economic environment. In fact, the US economy entered a downturn in August 1981—the same month Reagan signed the Economic Recovery Tax Act into law. That recession lasted another 14 months. During that time, the jobless rate climbed as high as 10.8%, up from 7.2% in the summer of 1981. On top of that, inflation and interest rates stubbornly hovered in double-digit territory. The combination of massive fiscal relief and tax cuts also contributed significantly to a massive widening in the US budget deficit—from 3.9% in excess of the annual budget for fiscal year 1982 to 5.9% in 1983.

However, once all the initiatives took effect, the US enjoyed over eight years of economic expansion, with real GDP growth averaging 4.1% per year. Meanwhile, the jobless rate fell to 5%—less than half the 10.8% rate when the expansion started. And for the first time since the early 1950s, the rate of inflation was lower at the end of the business cycle than at the start. In terms of fiscal finances, the budget deficit of 3.7% in 1990 showed no major deterioration from where it had been when the Reagan initiatives commenced eight years earlier.

Sharp Differences in Today's Economic Backdrop

The economic environment today is fundamentally and profoundly different than it was when Reagan entered office. First, the US economy is now in its eighth year of expansion, despite generating only modest GDP growth averaging around 2%. These past eight years have seen only a steady decline in the jobless rate to 4.9%—what many consider to be full employment. And inflation, which hasn't been in double-digit territory for decades, has remained quite low, hovering around 2%. At the same time, official interest rates are barely above zero and the yield on 10-year US Treasuries is roughly 2.3%.

Certainly, today's favorable economic and financial climate raises the odds of a successful outcome for Trump's proposals. Simply put, it should be much easier for Trump's stimulus to keep the economy moving forward than it was for Reagan's initiatives to reverse an economy in decline.

That's not to imply that the success of the Trump plan is a foregone conclusion. In fact, we have medium- and longer-term concerns with Trump's fiscal initiatives.

Cautions and Concerns

First, no major fiscal initiative of this scale has been tried when the jobless rate has been this low. If the fiscal initiatives spark a surge in growth (as they should), the demand for labor will far outweigh the available supply. That seems especially likely, since many companies are already saying that they can't find an adequate supply of skilled labor. The rising costs from demand pressures could come in a variety of areas. For example, a $1 trillion infrastructure plan seems aggressive, given that current construction spending only amounts to $1.15 trillion a year. Clearly, the scale and speed of the plan's implementation matter a lot. Also, a push by business to invest and rebuild its manufacturing platform would add pressure to a variety of commodities—and a net tax cut would increase consumer demand as well.

Altogether, Trump's fiscal initiatives could push wage (and general) inflation into running well above market expectations over the next two to five years. In fact, if

Trump's proposals are enacted in full, we wouldn't be surprised to see annual wage growth around 4%–5% in a few years, and headline and core inflation in the 3%–4% range. In turn, these wage and inflation pressures could spark a faster pace of rate hikes by the Federal Reserve—not something that's currently on the financial markets' radar as a high risk.

Second, the tradeoff on borrowing costs and federal debt today is the exact opposite of that in the early 1980s. Long-term borrowing costs in the early 1980s were prohibitively high (10-year Treasury yields of 15%), but the federal debt burden was relatively low (debt-to-GDP ratio was roughly 30%). Today, borrowing costs are low (10-year Treasury yields about 2.35%), but the US debt-to-GDP ratio is much higher (approximately 105%).

Critics will argue that embarking on several major fiscal stimulus initiatives is a risky strategy, especially given the government's elevated debt levels. Yet the way we see it, past debts and future promises will consume a country if it does not generate adequate nominal growth.

If fully implemented, Trump's plan could easily bump nominal GDP growth to 6% for an extended period, creating an environment for legislators to focus on a longer-term budget strategy. Many forget that President Reagan was able to get fundamental entitlement reform passed as well, something that is desperately needed today. Indeed, based on baseline budget projections from the Congressional Budget Office, mandatory entitlement programs will account for two-thirds of all federal outlays in 10 years. During the start of Reagan's presidency the share was 45%, and then declined modestly over the next decade as the legislated reforms took effect.

So the final verdict on Trump's fiscal plan will depend on two things: first, getting all of his tax, infrastructure and regulatory initiatives enacted; and second, passing budgetary reform down the road. That second part isn't on the drawing board today, but it's as important as this first part. Without budgetary reform, the US faces an unsustainable situation in which its future revenue flow will never match its future promises and obligations. ■