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TAKING STOCK: HOW REAGANOMICS LED THE UNITED STATES TO ITS CURRENT FISCAL DILEMMA

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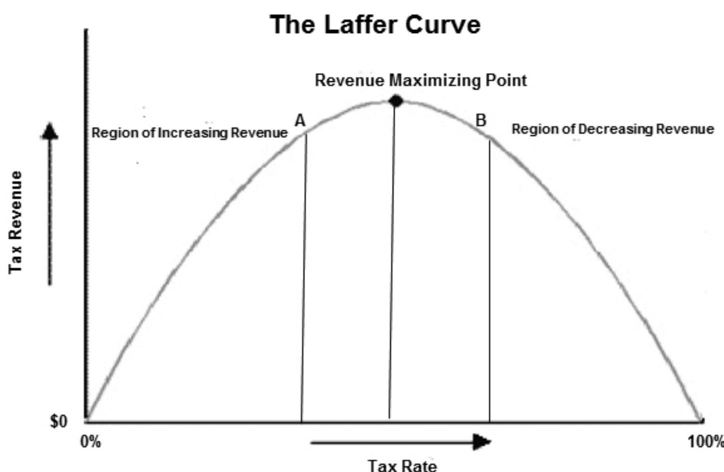
I recall watching a particular episode of ABC's "World News Tonight" in August 1985. Canadian-born anchor Peter Jennings announced the news "bombshell" that President Reagan's Budget Director David Stockman resigned. My father and I were devout "Reaganites" even though we lived in Canada, and we always liked to keep up on what was happening in U.S. politics. We also liked Ronald Reagan's tough stance against Iran following the Islamic Revolution of 1979 and the "evil empire" of the Soviet Union. I did not completely understand what was going on in the U.S. economy, even though I did like the idea of smaller government, reduced taxes and an expanded military.

The following year Stockman wrote a book called *The Triumph of Politics: Why the Reagan Revolution Failed*.[1] It identified the perils of having too big a welfare state, high federal spending and excessive subsidies. It argued that government should be smaller and explained why cutting taxes could help the economy. It also explained why various reforms could possibly increase tax revenue and why U.S. government spending should be cut in order to cover any potential tax revenue shortfall.



I always found the Laffer Curve intriguing. Arthur Laffer was the chief economist at the Office of Management and Budget from 1970 to 1972. He was associate professor at the University of Chicago when the curve was developed, and it looked somewhat similar to the graph in the lower left hand corner below (supposedly, the original was sketched on a napkin in 1974 when Laffer met with Nixon/Ford officials). The graph suggested that after a certain level of taxation, tax revenue falls as the disincentives produced by higher taxation outweigh the benefits for agents/individuals to produce additional income. On the other hand, if taxation remains or is reduced to below a certain level, the incentives to foster a growing economy become significant.

In 2006, I sat at Laffer's table at an industry event where he was to speak. Laffer was on Reagan's Economic Policy Advisory Board during 1981 to 1989. I was awestruck—I was getting to meet someone who was one of the major icons of U.S. economic policy (incidentally I also had some interaction with Stockman in the 1990s when I did some work for a major private equity fund he headed—it is a small world after all). Part of the incentive for the Reagan tax cuts was the postulation that the U.S. taxation system (as it was in 1980) could be on the right side of the Revenue Maximizing Point (such as at point B), and thus this level of taxation provided a disincentive to economic growth. If taxes are cut from a point on the right side of the curve and not below point A, the tax cuts could then pay for themselves.

Reaganomics rolled out as a tax-cut and spending-cut strategy. Coupled with the principles of supply-side economics, it was supposed to put the U.S. economy into a very strong economic and financial position. Stockman mentioned how some characterized the Reagan Revolution as the biggest economic policy development since the "New Deal" of the 1930s. However, as the early 1980s progressed, I do admit I

was getting a bit confused by the entire strategy. The probable reason for the confusion was that Reaganomics was being morphed into something different from what it was initially portrayed.

Stockman resigned after the Reagan Revolution became derailed—politicians eventually went around the country saying they would cut taxes and the tax cuts would pay for themselves (a "free lunch" as Stockman put it), and the political pundits put their own agenda ahead of the country's best interests and ignored the matter of spending cuts. They sold the easy story to the American public and ignored the hard story. Cutting spending in areas that included various types of government and social programs was still not popular and therefore would not be pleasant for politicians to undertake. Stockman's book explained how the political and government bureaucracy ultimately undermined an otherwise noble ideology intended to bring about many positive reforms.

The United States was never on the right side of the Laffer Curve, as the growing U.S. economy did not make up for the losses in government revenue due to tax cuts. (Data we have seen since the early 1980s confirms this view.) Stockman from the beginning was skeptical about the Laffer Curve's applicability to America as it stood at the dawn of the Reagan era, even though senior politicians and many others bought into its premises quickly. In my view, the Laffer Curve is intuitive but as with any theory, assumptions are required and attaching point values to parts of the curve is very subjective, especially given the complexity of most tax systems. In addition, once a theory is put into practice and the outcomes are not working out as planned, we must be ready to admit the mistakes, make adjustments, and adopt remedies very quickly to fix the undesirable effects. One of the insurance policies against the Laffer Curve going wrong was to adopt spending cuts in tandem—something that was subsequently dropped off by politicians as unnecessary, inconvenient or unpleasant as the train left the station.

In the past 30 years, we have continued to see various U.S. politicians singing the "tax cuts will pay for themselves" mantra despite the evidence to the contrary, since such a slogan resonates well with voters. Sometimes tax cuts have been promoted with the idea that the new deficits will indirectly "squeeze" other politicians to adopt the required spending cuts later on—but they rarely do so and therefore this political strategy also fails. Stockman predicted that with the new fiscal/tax positioning of the government in the 1980s due to the insufficient reforms, the United States would have deficits running into perpetuity because of the new imbalance created between tax revenue and spending. In the years that followed, this actually bore itself out as the U.S. government failed to avoid budget deficits (with the exception of part of the Clinton era, when interest rates fell and some taxes were raised or introduced) and the federal debt continued to escalate.

The contents of Stockman's book went mostly unheeded as the 1980s later bloomed to a great era of economic prosperity (I entered the actuarial profession during that time). The burgeoning economic growth was considered something that would help tax revenues catch up eventually. Stockman faded into history once he left politics, but he has been resurrected occasionally through media interviews, as some drifted back to look at the Reagan era with nostalgia, or wanted to seek out some of Stockman's updated insights.

This may seem to be a bit of interesting history lesson but some may not yet see the connection to the current U.S. and global environment. U.S. federal debt is huge at $17 trillion and will continue to grow, while easy monetary policy and cheap money is everywhere. Understanding the past can help us understand the direction of interest rates, inflation, debt, risk and its implications for investment management and the U.S. dollar. Stockman had some insights and identified behavioral traits that are still with us today.

CONTINUED ON **PAGE 12**

Comparing Debt Ratios (%)

Rank	Country	Category	Rating	Outlook	2012	2013*	2014*	2015*	2016*
1	Japan	Advanced	AA-	Negative	233.4	238.0	242.4	246.7	250.5
2	Greece	Advanced	CC	Negative	157.7	157.0	152.5	149.4	145.5
3	Ireland	Advanced	BBB+	Negative	121.5	125.8	125.0	123.5	121.5
4	Italy	Advanced	A+	Negative	120.0	119.7	119.3	118.7	118.0
5	U.S.	Advanced	AA+	Negative	102.9	105.6	107.5	109.4	111.9
6	Belgium	Advanced	AA+	Negative	97.4	97.8	98.2	98.3	98.8
7	Portugal	Advanced	BBB-	Negative	94.6	97.5	100.8	103.7	106.5
8	Iceland	Advanced	BBB-	Negative	97.1	92.1	85.3	80.9	73.8
9	Singapore	Advanced	AAA	Stable	91.3	88.5	86.1	83.9	82.9
10	France	Advanced	AAA	Stable	86.9	87.6	87.1	85.9	84.1
11	U.K.	Advanced	AAA	Stable	86.5	87.4	86.5	84.4	81.3
12	Canada	Advanced	AAA	Stable	83.1	81.0	78.5	75.6	72.6
13	Germany	Advanced	AAA	Stable	79.4	77.9	75.8	73.8	71.9
14	Hungary	Emerging	BBB-	Negative	76.9	77.1	76.8	76.0	75.3
15	Austria	Advanced	AAA	Stable	70.7	70.9	70.5	70.1	69.8
16	Spain	Advanced	AA	Negative	67.1	69.9	72.1	74.1	75.9
17	India	Emerging	BBB-	Stable	69.9	67.5	65.4	63.5	61.8
18	Israel	Advanced	A	Stable	70.0	67.5	64.8	62.6	60.6
19	Netherlands	Advanced	AAA	Stable	66.5	66.7	66.5	65.7	64.4
20	Brazil	Emerging	BBB-	Positive	65.0	63.8	62.1	60.3	58.6
21	Jordan	Emerging	BB	Negative	62.1	61.9	61.7	61.3	60.5
22	Poland	Emerging	A-	Stable	57.3	57.5	57.4	56.5	55.5
23	Malaysia	Emerging	A-	Stable	55.8	56.5	56.9	57.2	57.3
24	Finland	Advanced	AAA	Stable	52.7	55.0	57.3	59.2	61.1
25	Norway	Advanced	AAA	Stable	54.3	54.3	54.3	54.3	54.3
26	Morocco	Emerging	BBB-	Stable	53.8	54.0	53.8	53.0	51.7
27	Switzerland	Advanced	AAA	Stable	51.2	49.7	48.3	47.0	45.7
28	Kenya	Emerging	B+	Stable	50.9	49.6	48.9	48.3	47.0
29	Pakistan	Emerging	B-	Stable	50.9	49.5	47.8	44.5	41.2
30	Lithuania	Emerging	BBB	Stable	45.4	47.7	49.5	50.9	52.1
31	Slovenia	Advanced	AA	Negative	44.9	46.7	48.0	49.3	50.6
32	Slovak Repu	Advanced	A+	Stable	46.2	46.5	46.8	46.2	45.7
33	Denmark	Advanced	AAA	Stable	46.5	46.3	45.1	43.0	40.2
34	Czech Reput	Advanced	A	Positive	43.4	44.5	45.6	46.5	47.6
35	Philippines	Emerging	BB	Stable	46.0	44.3	42.8	41.4	40.1
36	Thailand	Emerging	BBB+	Stable	44.0	43.9	43.8	43.5	43.0
37	South Africa	Emerging	BBB+	Stable	42.8	43.8	43.5	42.0	38.7
38	Mexico	Emerging	BBB	Stable	42.1	42.0	41.9	41.6	41.4
39	Ukraine	Emerging	B+	Stable	43.5	41.5	39.5	35.0	30.7
40	Latvia	Emerging	BB+	Positive	41.0	39.8	38.1	36.8	36.2
41	Romania	Emerging	BB+	Stable	37.7	37.5	36.8	36.0	35.0
42	New Zealan	Advanced	AA+	Negative	36.4	36.5	36.1	33.7	31.7
43	Turkey	Emerging	BB	Positive	37.6	36.4	35.4	34.7	34.0
44	Argentina	Emerging	B	Stable	36.7	35.8	35.3	34.3	31.4
45	Colombia	Emerging	BBB-	Stable	35.4	34.0	32.7	31.5	29.9
46	Sweden	Advanced	AAA	Stable	34.9	32.2	29.3	26.2	22.8
47	Korea	Advanced	A	Stable	26.9	25.1	23.3	21.5	19.8
48	Australia	Advanced	AAA	Stable	24.8	23.3	23.6	21.8	20.6
49	Indonesia	Emerging	BB+	Positive	24.0	22.8	21.8	21.1	19.9
50	Nigeria	Emerging	B+	Stable	18.5	21.1	18.6	16.7	14.8
51	Bulgaria	Emerging	BBB	Stable	20.0	19.7	18.8	17.3	15.2
52	Peru	Emerging	BBB-	Positive	20.7	19.3	18.1	17.0	16.1
53	Kazakhstan	Emerging	BBB	Stable	14.1	15.3	16.2	17.4	18.1
54	China	Emerging	AA-	Stable	16.3	15.0	13.4	10.8	9.7
55	Chile	Emerging	A+	Positive	10.2	9.6	9.0	8.5	8.0
56	Russia	Emerging	BBB	Stable	8.8	9.5	11.3	13.5	15.9
57	Saudi Arabia	Emerging	AA-	Stable	7.1	6.2	5.3	4.4	3.7
58	Estonia	Advanced	A	Positive	6.0	5.7	5.4	5.2	4.9
59	Hong Kong	Advanced	AAA	Stable	4.0	3.8	3.6	3.4	3.2

Source: Standard & Poor's (long-term credit & outlook); International Monetary Fund (debt), * are estimates
http://online.wsj.com/article/SB10001424052748703789104576272891515344726.html

Stockman's charges against politicians for their inability to cut spending or unwillingness to raise taxes have been frequently validated by the regular Washington gridlock and the arguments over the debt ceiling. Since the 1980s, we have continued to see U.S. politicians promoting tax cuts, and even implying that future economic growth will somehow pay for those cuts. On the other hand, we have also seen politicians strongly entrenched in a position of not wanting to cut spending on anything. We have seen an anti-tax culture develop in the United States that is very detrimental to balancing the U.S. budget. We also see a culture of entitlement and a large welfare state, where no one wants their benefits reduced, claiming that they earned the rights to those benefits even though the country cannot afford these promises any longer, and such promises when granted were never prepaid. These attitudes and problems are not unique to the U.S. environment, but perhaps are more visible to the world than those of countries in similar dilemmas, as the U.S. political infighting is on big display globally through the various forms of media.

When we watch the political infighting in Washington, any potential resolutions barely reach an amount that comes close to 5 percent of the $17 trillion debt (they appear to be "nickel and dime" solutions). Most heavily debt-laden economies are also hoping that their economies can grow them out of their debt burdens—Japan, for example, is hoping that inflation will come to the rescue, increasing both tax revenue and potentially reducing the real value of debt. Nevertheless, it is becoming evident that we need big solutions to avoid an economic malaise at best and some sort of financial collapse at worst, as various countries drown under their own debt. As seen in the table to the left, debt-to-GDP levels have become very high. I believe that the low level of interest rates is the primary reason that many economies have avoided crises in the past few years. If these debt levels were achieved before the financial crisis of 2008 to 2009 when interest rates were substantially higher, a number of countries would have been in trouble before the crisis.

In a television interview given three years ago, Stockman suggested an idea that initially seemed bizarre but was rational in hindsight. He highlighted that the richest 5 percent of Americans have increased their wealth from $8 trillion to about $40 trillion (between 1985 and 2010) and that an excise tax of 15 percent on these individuals would raise $6 trillion in revenue, contributing significantly to federal debt reduction.[2] He remarked: "If [these politicians] were all put into a room on penalty of death to come up with how much they could cut, they couldn't come up with $50 billion, when the problem is $1.3 trillion,"[2] which just highlights the polarization of the problem. In a more recent account, it was remarked that "Stockman would subject the nation's top 10% of households to a levy equal to 30% of their wealth, payable over a decade"[3] in order to bring the United States away from the brink of a financial disaster. Stockman's newest book *The Great Deformation—The Corruption of Capitalism in America* further signals that there is serious trouble ahead, in part because of all the attempts to control and manipulate the financial system to achieve certain ends. In the past year, we have been hearing much about the rise in interest rates globally, and the paradigm used for the progression of investment returns is strongly based on historical data and analyses (which incidentally did help get us into the financial crisis, as financial models could not envision tail events greater than those that occurred in the past). From my view, the real jeopardy for the bond market is not rising interest rates due to an improving economy or Federal Reserve tapering as the headlines suggest, but the possibility that no one will want to buy the debt anymore. Political and economic analysts have argued for some time about when foreign governments will stop buying U.S. Treasury debt or even dump what they already own. This debate dates back to the 1980s when the United States started to run huge deficits and increased debt levels, and this tirade of criticism has been repeated so often that it is not taken too seriously anymore. However, we may get to a point that there is too much simply out there to buy, even if a central bank continues to step in. Major segments of the population down the road are going to have to make sacrifices if big solutions are not adopted now, and the victims could include the average person who will have assets eroded by high inflation. Investment activity and performance are going to be a confusing exercise, to say the least.

The primary lesson we need to understand from all this is that taxes need to be raised, spending has to be cut, or both—and that governments globally need to make big adjustments very soon, since the financial issues have been neglected for too long (of course, this approach is going to be painful for any economy to sustain, but it may be the only way out). This was the same principle understood at least by some during the Reagan years, but was subsequently ignored. If nothing is done to fix the current problems, then eventually Ms. Market or Mr. Inflation will have to make the adjustments, and these two do not represent one of the nicest pair I would want to reckon with. Unfortunately, a number of major countries are in similar circumstances, and it will be frightening to see them all punished at the same time.

ENDNOTES

1. Stockman, David A. 1986. *The Triumph of Politics: Why the Reagan Revolution Failed.* Harper & Row.
2. "David Stockman: The Voice of Reason," *http://independentreport.blogspot.com/2010/12/david-stockman-voice-of-reason-60.html*, Dec. 1, 2010.
3. Milburn, Robert. "David Stockman: Soak the Rich," <http://online.barrons.com> [path: http://blogs.barrons.com/penta/2013/10/11/david-stockman-soak-the-rich/], Oct. 11, 2013.

The views expressed herein are those of the author and do not necessarily reflect the views of Segal Rogerscasey.

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