Ronald Reagan and the Rise of Large Deficits

What Really Happened in 1981

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In the controversy over Ronald Reagan's legacy, the events of 1981 loom large. Critics contend that the large deficits of the 1980s were Reagan's fault, the product of an irresponsible plan to cut taxes and increase defense spending that was founded on obviously overoptimistic economic assumptions. Sidney Blumenthal has been one of the most strident commentators. In 1993 he used his *New Yorker* column to repeat the charge that the Reagan administration had manipulated the budget numbers, lighting the fuse for the deficit explosion. Even generally sympathetic accounts of Reagan deplore his budget record. Thus, the 1998 Public Broadcasting series *American Experience* credited Reagan for his role in ending the Cold War but decried his budget and economic plans.

The critics are wrong. Because budget projections in early 1981 indicated massive surpluses, it seemed to be possible, based on the data then at hand, to cut taxes, increase defense spending, and still balance the budget. The Reagan administration's economic forecasts were, at most, only slightly more optimistic than other forecasts at the time. Throughout 1981, neither Reagan's forecasters nor other forecasters perceived that the country was verging on the worst recession since the Great Depression. That recession drastically reduced inflation, benefiting Americans, but it also produced large budget deficits that ended only recently.

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The First Reagan Plan

Despite many claims to the contrary, the Reagan proposal *never* assumed that tax cuts would increase revenues. Instead, the proposal followed the normal budgeting convention that reducing tax rates would decrease revenues below their projected levels (Anderson 1988, 152–57). Under the policies in place at the beginning of 1981, revenues were projected to increase rapidly. As we shall see later in more detail, so large were those increases that massive budget *surpluses,* not deficits, were projected for the mid-1980s. Given the expected surpluses, taxes could be cut and the budget still balanced.

Still, a knowledgeable critic might respond that the original Reagan program relied on a wildly optimistic economic forecast; even if the Reagan numbers never directly assumed that tax cuts would increase revenues, the economic forecast predicted unreasonably high revenues. David Stockman's book *The Triumph of Politics* (1986) is oft-cited proof of this charge. In Stockman's words, "The budget numbers printed in February 1981 said you could have a big tax cut and a big defense buildup, and still have a balanced budget by 1984. That would be followed by a $28 billion surplus by 1986. But it all depended upon Rosy Scenario" (396). The infamy of the Reagan administration's initial forecast has become so familiar that many refer to it as *the* Rosy Scenario, with the capital letters denoting its notoriety, as in Stockman's book. To ascertain whether the original Reagan program was based on the economics of the free lunch, we must consider that first forecast.

How do we measure whether the initial forecast was really rosy? It has been condemned as rosy by comparison with what actually happened. The administration's forecasted deficit for fiscal 1982, released in February 1981 with its proposed program, was $45 billion (Office of Management and Budget [OMB] 1981, 2), whereas the actual deficit turned out to be $128 billion.[1] Even though many of Reagan's proposals were eventually enacted, the deficit forecast was inaccurate largely because of the inaccuracy of the economic forecast. But hindsight is, as they say, twenty-twenty. To understand the actual degree of optimism of the Reagan forecast, we must view the world as Stockman and his compatriots did in 1981, not as it turned out to be months or years later. Thus, we must consider what those in the Reagan administration knew at the crucial times when that administration's tax and spending policies were created and implemented.

One way to do so is to compare the Reagan forecast with others made at the same time. Table 1 provides the administration, Congressional Budget Office (CBO),

1. Although the plan was first released in February, many of the details did not come until later. Moreover, the 1982 estimate and the actual figures are not directly comparable, because the latter includes all off-budget entities. The 1982 deficit, excluding off-budget entities, was $110.6 billion. OMB estimates that, adjusted to conform with the full budget totals, the original Reagan proposal produced a deficit of $61.7 billion (OMB 1983, part 6).

and Blue Chip GNP forecasts of growth and inflation for calendar years 1981 and 1982, as those forecasts stood early in calendar year 1981.[2] (In those days, forecasts were for GNP, not GDP.)

Compared to what happened, the administration's forecast was wildly inaccurate, projecting more than 4 percent real growth in 1982, when the economy actually declined almost 2 percent. But the CBO and Blue Chip were also wildly inaccurate in their real growth projections. Relative to the CBO and Blue Chip, Reagan was still overly optimistic. Although not trivial, that excessive optimism—1.7 percentage points greater growth than the CBO projected—was not nearly so large as the actual mistake in each forecast. Nevertheless, if this information were all we possessed, the

Table 1
Economic Forecasts of March 1981, for 1981 and 1982, Compared with Actual Figures

	Reagan Administration	Congressional Budget Office	Blue Chip	Actual Figures
Forecasts for 1981				
Real GNP growth	1.1	1.3	1.3	1.9
GNP deflator	9.9	10.3	9.9	9.4
Nominal GNP growth	11.1	11.8	11.3	11.6
Forecasts for 1982				
Real GNP growth	4.2	2.5	3.7	–1.9
GNP deflator	8.3	9.2	8.6	6.0
Nominal GNP growth	12.8	11.9	12.6	4.0

Note: All figures are percentages. All numbers are year over year. Actual figures are as recorded in the early 1980s and do not reflect subsequent benchmark revisions of GNP (see Council of Economic Advisors 1983 and 1984, appendix B).

Sources: OMB, *Fiscal Year 1982 Budget Revisions* (March 1981); CBO, March 1981 Report; *Blue Chip Economic Indicators* 1981.

2. I follow the normal budgeting convention and present economic forecasts in calendar years and deficit forecasts in fiscal years. Blue Chip reflects a consensus of leading private forecasts (Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*).

Reagan administration could be found guilty of some excessive optimism, even when measured against the yardstick of other contemporaneous forecasts.

But real GNP growth is not the whole story. The issue is whether the deficit forecast was rosy by comparison with other forecasts. Deficits, of course, equal outlays minus receipts. The driving force for the computation of receipts is nominal, not real, GNP.[3] Table 1 reveals that the nominal GNP forecasts were more similar than the real GNP forecasts, particularly when we compare the administration and CBO figures. The nominal GNP forecasts were accurate for 1981, but none of those forecasts predicted the 1982 recession or the disinflation that accompanied it. In 1982, nominal GNP grew by only one-third (or less, depending on the forecast) of the predicted amounts.

What of the other half of the equation, outlays? Here, other economic assumptions are relevant. For example, error in the projected unemployment rate affects the discrepancy between forecasted and actual unemployment benefits as well as discrepancies for other programs sensitive to the unemployment rate. (Of course, unemployment rates themselves are highly correlated with real GNP growth.) Although the administration's (7.2 percent) and Blue Chip's (7.3 percent) unemployment forecasts for 1982 were virtually identical, CBO's (7.9 percent) was closer to the actual (9.7 percent). Moreover, interest-rate projections are important in determining the expected outlays for programs sensitive to the interest rate. For example, as the deficit increased, it had to be serviced. Reagan's projection of one 1982 interest rate—8.9 percent for the three-month Treasury bill—was significantly lower than the actual rate, 10.7 percent.[4]

Table 2 compares the three forecasts' misestimates of the 1982 deficit. Budget technicians frequently characterize the deficit misestimates by identifying descrepancies due to three variables: inaccurate economic assumptions, policy changes proposed but not enacted, and technical assumptions made in the original forecast that turned out to be inaccurate (for example, the number of individuals who would qualify for a particular benefit or the number of bank failures that would require payment of deposit insurance). A word of caution is in order. The split between economic, policy, and technical sources of error must be somewhat arbitrary, at least in practice. For example, interest rates affect the extent to which banks and savings-and-loan institutions fail. Yet mistakes in estimating that failure rate are classified as technical even if changes in interest rates influence the failure rate.

3. Nominal GNP was especially important before the personal income tax was indexed for inflation. Other aspects of the GNP forecast besides its size are relevant, including the distribution of income among various taxable sources and between taxable and nontaxable components.

4. One might ask why estimates of the GNP deflator were high while those of interest rates were low. The answer appears to be that in the late 1970s inflation had caused a negative spread between interest rates and the GNP deflator, harming creditors. Determined not to make that mistake again, creditors widened the interest rate–GNP deflator spread more than many forecasters had predicted.

Moreover, the order in which the estimates are made matters. Calculating errors from economic and policy changes first, and calling the residual "technical," as is the current practice, can produce somewhat different results from those derived when the order is changed. Therefore, care must be taken when comparing the estimates of different individuals or organizations. What is important for our purpose, however, is the use of a consistent estimating method. Our primary interest is comparison of the forecasts, not the precise reliability of the absolute numbers. To give some sense of the crudeness of the method and to avoid the false appearance of precision, the numbers are rounded to the nearest billion dollars.

Table 2 shows that the Reagan projection of the 1982 deficit, made early in 1981, proved to be optimistic by $70 billion because of its economic assumptions; most of the error resided on the receipts side. This is undoubtedly a large amount of error, particularly given that the deficit was $128 billion. Substituting the CBO or Blue Chip economic forecasts for those of the Reagan administration yields a large economic error in the deficit forecast as well, though not so large as the administration's.[5] All three forecasts were wildly inaccurate primarily because of their failure to predict the recession and the accompanying disinflation. Thus, based on the knowledge available to the Reagan administration *at the time* it released its forecast, that forecast was, at most, mildly optimistic. If the Reagan forecasters can be said to have worn rose-colored glasses, then the same hue must be acknowledged to have tinted the glasses of other forecasters as well (CBO 1981b, 37).[6]

The disparity in real GNP growth projections among the early 1981 forecasts grew for the "out years," 1983 and 1984. The administration's initial 1981 forecast, predicting real growth of 5 percent for 1983 and 4.5 percent for 1984, significantly exceeded those of Blue Chip (3.7 and 3.0) and of the CBO (2.7 and 3.0). Because the administration projected the GNP deflator's increase would fall to 6.0 percent by

Table 2
Amount of Error in Deficit Forecasts for 1982, by Category (in billions of dollars)

	Reagan Administration	Congressional Budget Office	Blue Chip
Receipts	48	52	43
Outlays	22	9	13
Total	70	61	56

Source: Office of Management and Budget (see footnote 5).

1984 (compared to an actual 3.8 percent), whereas the CBO and Blue Chip projected much smaller declines (8.1 and 8.2 percent, respectively), the three forecasts had nominal GNP projections much closer to each other than their real growth forecasts. Thus, if table 2 were extended to include the mistakes of the out-year forecasts, then the three forecasts would retain their relative positions in misestimating the deficit, but the mistakes would be bigger. For example, the CBO disagreed that the Reagan plan as enacted would produce a deficit of only $22.9 billion in 1982 and a balanced budget in 1984. But the CBO's published projections for those years—deficits of $55 billion for 1983 and $50 billion for 1984—though closer, were still wildly inaccurate.

Stockman and Darman in the White House Parking Lot

Thus far we have considered forecasts made at the beginning of 1981.[7] Although proposed in February, the Reagan reforms were not implemented until much later. The crucial tax package was passed in July. Surely, by then, the participants in the budget drama of 1981 realized that large deficits would occur. This view is reenforced by Stockman's 1986 description of his famous conversation with Richard Darman in the White House parking lot on July 23, 1981:

> We paced around the parking lot some more.
>
> "I don't know which is worse," Darman said, "winning now and fixing up the budget mess later, or losing now and facing a political mess immediately."
>
> . . .
>
> "Let's get at it," he urged. "We win it now, we fix it later. I can think of worse choices." (263)[8]

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5. Each published *President's Budget* contains an analysis of the difference between the numbers proposed in the budget for the last completed fiscal year and the actual numbers. The analysis for fiscal 1982 appeared in the *President's Budget for Fiscal Year 1984,* part 6. Internally, the Office of Management and Budget produces a similar analysis substituting different economic forecasts, such as CBO and Blue Chip, for that administration's forecasts. Those analyses for 1982 and 1983 are on file with the author.

6. The estimates for CBO represent the midpoint of estimates that CBO presented as ranges.

7. A considerable literature exists on the development of the budget in Reagan's first year, some of which considers the initial forecast. For example, Joseph White and Aaron Wildavsky (1989, 341) note the unpredicted recession and compare the similar nominal GNP forecast in President Carter's last budget and President Reagan's first. Allen Schick (1990, 137–38) explicitly rejects the charge that Reagan intentionally created deficits to limit future spending. Although both books' authors criticize the original Reagan forecast, they do not present the detailed comparisons of various forecasts contained in this article; nor do they consider the topic of the remainder of this article: the continual failure through early 1982 of forecasters, both inside and outside the government, to appraise the economy accurately. In *Reaganomics,* William Niskanen concludes that the "initial Reagan forecasts did not deserve the later characterization as a 'rosy scenario'" (1988, 8). Like the other authors just cited, Niskanen does not track the effect of the forecast mistakes on the deficit in 1981 and 1982. He does note in passing the failure of the 1982 forecast (228), but he does not tie that failure to the issues considered here.

8. In his article cited earlier, Sidney Blumenthal makes much of the administration's failure to make a mid-course correction in the summer of 1981.

This passage does *not* show that Stockman and Darman knew of the massive deficits that would follow. What prompted their gloom was the increasing size of the 1981 tax bill and the administration's failure to achieve all of the spending cuts it desired. As of July, there was no reliable evidence of the looming recession. Consider the following series of headlines from the Blue Chip monthly reports for March 1981 through July 1981.

March: 1981 Economic Consensus Inches Upward

April: 1981 Full Year Consensus Forecast Continues to Pick Up Steam

May: 1981 Consensus Forecast Tilts Up Again

June: The Recovery Continues

July: Economic Exuberance Envisioned for 1982

Those headlines reveal that most economists remained optimistic. Although the Blue Chip forecasts of real GNP growth for 1982 had decreased from 3.6 percent in January to 3.2 percent in July, that change provided no indication of the massive drop soon to come.

In this light it is clear that Stockman and Darman could not have known of "$200 billion deficits as far as the eye can see"—a phrase Stockman used much later. Instead, they were recognizing that they could not achieve a balanced budget and that large deficits (by the standards of 1981) would occur. In his book, Stockman himself discussed projecting in August 1981 that the deficit would reach $112 billion in 1986 (1986, 272). Although deficits of that size were shocking in 1981, if the deficit had stayed at that level through the mid-1980s, we would now regard its containment as a tremendous victory.

The CBO's baseline budget projections, published in July 1981, provide an additional indication of the budget world's ignorance during the summer of 1981. Assuming that the Reagan policies would not be adopted—that is, taxes and domestic spending would not be cut, and defense spending would not be increased—the CBO projected that there would be a budget *surplus* of $18 billion in 1983, growing to a surplus of $209 billion in 1986 (CBO 1981a, xiv). Such projections, not reliance on extreme economic assumptions, explain how the Reagan administration could propose a tax cut and defense-spending increase, yet still expect to avoid massive deficits.

The 1982 Plan

If the Reagan administration planners did not understand the severity of the problem in the summer of 1981, can one claim that they surely understood soon thereafter? If they did, then the criticism of the Reagan administration is correct, at least with regard to the next round of deficit forecasts. When administration forecasts are compared to the CBO and Blue Chip forecasts, however, the charge is *still* inaccurate. Blue Chip continued to revise its 1982 economic forecast downward, but not until November was there consensus that a recession had started. Moreover, the belief was that the recession would be short and not particularly severe. That belief persisted into calendar year 1982, when forecasts for 1983 were released. Table 3 repeats the numbers in table 1, this time using forecasts made early in calendar year 1982 for 1982 and 1983.

Months after the Reagan "revolution," neither the Reagan administration nor the CBO nor a consensus of private forecasters understood the calamity that had already begun. Moreover, although Reagan's forecast is significantly rosier on GNP growth, its prediction of the decline in the GNP deflator was more accurate than the other forecasts, though still wildly inaccurate. The administration's projected nominal GNP was not significantly different from that of the other forecasts.

Table 4 repeats table 2's analysis of deficit misestimates, this time for fiscal year 1983. For critics of the Reagan forecasts, this table reveals a startling fact. In the midst of the

Table 3
Economic Forecasts of Early 1982, for 1982 and 1983, Compared with Actual Figures

	Reagan Administration (February)	Congressional Budget Office (February)	Blue Chip (March)	Actual Figures
Forecasts for 1982				
Real GNP growth	0.2	–0.1	–0.3	–1.9
GNP deflator	7.9	7.5	7.5	6.0
Nominal GNP growth	8.1	7.5	7.2	4.0
Forecasts for 1983				
Real GNP growth	5.2	4.4	3.8	3.7
GNP deflator	6.0	7.3	6.9	3.8
Nominal GNP growth	11.5	11.9	11.0	7.7

Note: All figures are percentages. All numbers are year over year. Actual figures are as recorded in the early 1980s and do not reflect subsequent benchmark revisions of GNP (see Council of Economic Advisors 1984 and 1985, appendix B).

Sources: OMB 1982; CBO, *The Prospects for Economic Recovery* (February 1982), xviii; *Blue Chip Economic Indicators* 1982.

worst recession since the Great Depression, the forecasters were, if anything, even more inaccurate than they had been the year before. Relative to those of the CBO and Blue Chip, OMB's performance had improved a bit, mainly because its projections of outlays were better than those of the year before.[9] This is not to say that budget officials didn't recognize by early 1982 that they had serious problems. Indeed, by that time they were projecting unprecedented deficits. The extent of the mistakes and the rapid disinflation confounding their estimates, however, were not understood even at that late date.

William Niskanen has raised another criticism of the Reagan record. He argues that the early forecasts, though not a Rosy Scenario, had a major technical problem in that the assumed real GNP growth was too high to be consistent with the assumed monetary policy (Niskanen 1988, 8).[10] Even if that was the case, we have seen that substitution of forecasts regarded as more credible, such as the CBO's or Blue Chip's, produces most of the same forecast error for the deficit. Moreover, in its early 1982 forecast (table 3), which Niskanen does not analyze, the administration also projected higher real growth than did the CBO and Blue Chip, with a lower GNP deflator. Yet, as table 4 reveals, the non-administration forecasts would have produced virtually identical errors in the deficit forecast.

For the rest of the 1980s, the forecasts would improve. No economic assumptions after 1983 would approach the inaccuracy of those made in the first two Reagan years, whether by the administration, the CBO, or the Blue Chip consensus.[11] But the damage had been done.

Table 4
Amount of Error in Deficit Forecasts for 1983, by Category (in billions of dollars)

	Reagan Administration	Congressional Budget Office	Blue Chip
Receipts	66	65	67
Outlays	6	2	7
Total	72	67	74

Source: Office of Management and Budget (see footnote 5).

9. It is important to remember that the fiscal 1983 mistake is composed of misestimates for the last quarter of the calendar 1982 economy and the first three quarters of calendar year 1983. Thus, the fact that all forecasts successfully predicted growth for calendar year 1983 is not as remarkable as it might seem. Moreover, the misestimates of the GNP deflator in table 3 are greater than those in table 1.

10. Ironically, during the spring of 1981 the Reagan plan was criticized for being too *inflationary* because of expected deficits.

Noneconomic Problems with the Reagan Projections

As already noted, deficit forecasts can err for reasons other than mistaken economic assumptions. Some of the error can be attributed to policy variations or technical reasons. Perhaps the Reagan budgets would have made forecast errors even worse, for example, by proposing larger defense-spending increases or tax cuts than Congress enacted. For the 1982 and 1983 Reagan budgets, the combined deficit underestimates amounted to a whopping $167 billion.[12] By far the largest share of the underestimation—$137 billion, or 82 percent—resulted from the mistakes in economic assumptions discussed previously. Had Congress fully enacted the policies proposed in the Reagan budgets, the deficits would have been higher, but only by $3 billion. Largely because receipt reductions for 1982 were not as great as Reagan proposed, because of a delay in the effective date of the tax cut, policy differences from the Reagan program did decrease the deficit for that year by $15 billion. Reagan policies that would have reduced the deficit by $12 billion, mostly proposals for lower domestic and entitlement spending, were not enacted the next year. Thus, in the aggregate, the policies in the first two Reagan budgets did not significantly contribute to the mistaken forecasts.[13]

Concluding Thoughts

Readers critical of this article's thesis might raise two objections. The first is that Stockman, the architect of Reaganomics, has himself renounced his work. Although true, that fact hardly ends the discussion. Moreover, I agree with William Niskanen, who as a member of the Council of Economic Advisors was Stockman's colleague, that Stockman's book "understate[d] the effects of the Reagan economic program and Stockman's own contribution to that program" (Niskanen 1988, 293). In any event, whether one accepts the view of this article or the theories it rebuts, Stockman's main policy thesis remains intact and must stand or fall on arguments unrelated to those made here—the Reagan years showed that spending cannot be cut drastically, and thus massive tax increases were needed to eliminate the deficit.

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11. Of course, the Bush budgets for fiscal 1991 and 1992 broke the string of relatively accurate forecasts that had begun after those for fiscal 1983. Indeed, the budget for fiscal 1992, released in early 1990, became the mother of inaccurate budget projections.

12. The projected deficits were $6.2 billion for 1982 and $107 billion for 1983; actual deficits were $128 billion and $208 billion, respectively.

13. This argument does not deny that large increases in defense spending and decreases in taxes actually occurred. The point is that congressional refusal to follow Reagan's plans fully did not, considering all of the spending and tax changes Reagan proposed in the aggregate, contribute significantly to the mistaken forecasts. The mistakes in the Congressional Budget Resolutions (CBRs) for 1982 and 1983 were very close to those of table 5. The total deficit underestimate was $165 billion, $135 billion (or 82 percent) of which resulted from faulty economic forecasts. OMB publishes these numbers regarding deficit mistakes in each *President's Budget*. CBO currently publishes its estimates of the changes to the CBRs in its annual outlook (see, for example, CBO 1999, appendix B).

The second objection is that forecasting the turns of the economy is widely known to be difficult, and hence the preceding evidence presents nothing new. Of course, this observation is inconsistent with acceptance of Stockman's placement of blame on Rosy Scenario, although some have raised both points. At the least, my argument is inconsistent with the popular view of what happened in 1981. Perhaps more important, even the academic literature lacks the comparison of the administration's and other early 1981 forecasts' deficit estimates presented here as well as a detailed discussion of the failure to assess the economy accurately in the summer of 1981 and in early 1982.

Despite the protestations of Sidney Blumenthal, PBS, and many others, the problem of large deficits was not created by malevolence or even overoptimism. A major source of the problem was a deep recession, the severity and, at first, even the existence of which were unforeseen. This view of the problem—that it sprang from failure to understand the economy—helps to explain the fundamental political dilemma that arose: voters will support neither large deficits nor the changes in spending and tax policy to eliminate or significantly reduce them. The voters and politicians did not favor *creating* large deficits but, once they arrived, a majority of both groups for years opposed steps that would eliminate them.

An explanation of the role of widespread ignorance in creating large deficits is not as exciting as explanations that seek to find villains to blame for our troubles. Nowhere is it written, however, that the truth must be exciting.

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