



The Budget Balance Drama: Will Past be Prologue?

By Barbara Chow

In similar actions, Presidents Ronald Reagan and Bill Clinton both signed the most significant economic legislation of their presidencies within seven months of taking office (August 13, 1981 and August 10, 1993), after hard fought struggles with Congress. In both cases these landmark bills helped determine an economic course that dictated much of what happened and indeed much of what was possible in the ensuing seven years of their administrations. In both cases, the economic and budgetary projections undergirding the plans significantly understated their true momentum – resulting in far bigger deficits and surpluses than originally projected.

President Bush has laid down the gauntlet for Act Three; the centerpiece is, again, a significant tax cut, similar to Reagan's 1981 Economic Recovery program. If past is prologue, the President will win and he will win soon. History suggests that the proposal will survive the congressional process structurally intact (although the specifics may be very different than proposed). It is also likely to profoundly affect the rest of his term and the political fortunes of those in Congress.

Some differences are evident. This tax cut proposal will be subject to the full weight of historical knowledge and precedent. Democrats are mounting a strong campaign emphasizing debt reduction and outlining the dangers of a significant tax cut based upon the uncertainty of surplus estimates. Republicans are conscious of the budgetary problems created during the Reagan era and are leery of repeating the pattern. And the federal budget is in better shape to absorb a major tax cut than it was 20 years ago.

This paper briefly examines the philosophy and content of the Reagan and Clinton initial budget proposals and the economic and political developments that followed. It concludes with some potential lessons from Acts One and Two for the latest turn in the budget saga. It also poses the question of whether this budget turbulence, relatively wild swings from feast to famine, is good and appropriate for the country. Should we look for ways to moderate these swings or does the nation benefit from big changes in fiscal policy every ten years?

Act I: The Reagan Economic Recovery Program (1981): Where We First Learned About Overshoots.

President Reagan took office and the Senate Republicans took control of the Senate in 1981 during a period of enormous national concern about the direction of the country coupled with personal anxiety. Inflation rates were at their highest level since the Civil War, unemployment stood at 7.6%, creating a “misery index” (inflation plus unemployment), which topped 20%, the highest in the postwar period. The nation felt adrift and weak and the institutions of the federal government were viewed as largely ineffective.

Reagan came to office committed to an economic program of significant individual income tax cuts, regulatory relief for private companies, higher defense spending and tight monetary policy aimed at curbing inflation. This program, he argued, would revive economic growth, lower unemployment, and restore the nation’s international standing. He also said that the higher economic growth would eventually increase revenues and lead to a balanced budget, which he promised to achieve by 1984.

Central to his economic reasoning was the belief that domestic government spending was recklessly large and in fact partially to blame for the poor economy, creating a dysfunctional drag on private initiative. He believed that the only solution was to deprive the government of its income, thereby diminishing its claim on private sector resources. In his 1981 address to a joint session of Congress to promote his economic recovery program, President Reagan noted, “The answer to a government that’s too big is to stop feeding its growth. Government spending has been growing faster than the economy itself.”

Judged against its economic objectives, Reagan’s Economic Recovery Act was largely successful. Most importantly, the economy recovered. The country came out of recession; growth slowly picked up, resulting in the then longest peacetime expansion on record; inflation moderated; and, unemployment fell 30% by

1989. From a budget composition perspective, Reagan got what he promised: defense spending increased by over 40% from 1981 to 1989 while domestic spending was significantly constrained.

Viewed purely through a balance sheet lens, however, Reaganomics did not perform as promised. Higher economic growth did not offset the loss of tax revenues and because of this shortfall, coupled with increased defense spending, budget deficits and the national debt exploded during the 1980s, doubling as a share of GDP.

The path set in 1981 charted a budgetary course that significantly overshot its mark. The cumulative deficits over the 1981 through 1984 timeframe were supposed to be a modest \$122.2 billion. They turned out to be \$600.2 billion. The balanced budget promised in 1994 became a \$208 billion deficit. Inflation turned out to be much lower than predicted but unemployment remained much higher. The national debt doubled from \$1,004 billion in 1981 (in real 1987 dollars) to \$2,028 billion in 1989 and increased as a share of GDP from 27% to 42%.

The political consequences of the 1981 Reagan economic program were not fully realized on his watch or by his presidency. Buoyed by a strengthening economy Reagan swept into a second term winning 59% of the vote and taking electoral victory in 49 states. He left office with a 56% approval rating. While the public gave him extremely poor marks for his handling of the deficit (16% approval), 63% rated him as an above average president, far higher than any of his contemporaries at the time.

Although Reagan’s political standing did not suffer as a result of his early budget activity, Republicans in Congress (and his successor in the White House) did pay a price. In 1986, the Senate switched parties again, in part because of the politically tough votes Republican members were forced to take to pass deficit reduction proposals needed to correct the budget problems created by the 1981 tax cut.

Intermission: The First Bush Pays the Piper

The economic and budgetary situation that President Bush inherited was not a happy one, made problematic by the Reagan era deficits. Already in Reagan's last year, some economists were predicting a recession. Unlike Reagan, Bush decided to wait a year before launching his major economic program. This meant that his economic initiative would coincide with the coming recession, perhaps too close to the election. Moreover, the traditional levers used to help mitigate or deflect an economic slowdown had already been pulled to their maximum by the large built-in federal deficits. Instead of pump priming, President Bush was forced to expend virtually all of his political capital to strike a deal with Democrats that contained a significant tax increase, needed to staunch the flow of red ink.

Act II: The Clinton 1993 Economic Plan: Where Some History Repeats Itself.

President Clinton took office during a period of lingering economic stagnation. Real wage growth was negative, economic growth had averaged 1.7% in the previous four years, unemployment had crept back up to 7.5% in 1992, and the budget deficit had ballooned to \$290 billion, the highest in history. Clinton's famous war room slogan, "It's the economy, stupid" was reflective of the anxiety of a working public worried about whether people would keep their jobs and whether earnings would ever start to grow again.

Shortly after coming to office, Clinton became convinced that restoring fiscal discipline was the key to the long-term health of the economy and by reducing interest expenses it would be possible to make the kinds of investments he thought essential for future economic prosperity. In his first State of the Union, Clinton explained, "We are cutting the deficit so that government can make the investments that help us become stronger and smarter and safer."

Like the first hesitant Bush facing a budget still deep in deficit, Clinton did not have the luxury of jump-starting the economy with a major

spending or tax cutting program. Instead, along with a modest fiscal stimulus package for 1993 (which ultimately failed), he proposed one of the most aggressive deficit reduction programs in history. The goal of the 1993 economic program, which contained highly unpopular tax increases (including for Social Security) combined with modest spending reductions, was to reduce the cumulative deficit by \$505 billion over the 1994-1998 timeframe. Subsequent plans sought to reach a balanced budget by 2002. Instead, the 1993 plan produced deficit reduction more than twice as large – \$1.2 trillion – and resulted in a surplus budget in 1998, four years ahead of schedule. The arrival of this surplus, and the resulting decline in interest expenses, made possible significant investments – especially in education – achieving in part what Clinton sought from the beginning.

The existence of what are by now huge surpluses has led to the question of whether there can be too much of a good thing. Some analysts speculate that surpluses of the current scale may be depressing economic activity by reducing private sector disposable income and wealth. Federal Reserve Chairman Alan Greenspan has worried out loud about federal acquisition of private assets once the federal debt has been fully retired.

Unlike Reagan who only gradually experienced the political fallout of his first economic act, for Clinton political repudiation of the 1993 economic program was swift. In 1994, in some part due to the politically perilous votes taken the previous year, Democrats lost both houses of Congress, and Republicans took full control for the first time in 40 years. However, like Reagan, Clinton himself easily won reelection two years later, winning 30 states, and beating his opponent by 9%.

At the end of Clinton's second term, the economic and budgetary picture had dramatically improved. The deficit that peaked in 1992 had turned to surplus by 1998. Projections for 2001 suggest a surplus of over \$250 billion—the fourth year in a row of surplus, for the longest such period since the 1920s. The "misery index" is at its lowest level

in three decades. GDP growth has averaged 3.7% and productivity has maintained steady growth at high rates.

Act III: Bush The Second Endorses A Major Tax Cut: Will the Past be Prologue?

Now, another president has proposed yet another major change of direction, this time a \$1.6 trillion across-the-board tax cut (\$2.1 trillion if debt service is factored in) that is roughly the same size, as a share of the economy, as the Reagan tax cut. Its costs could increase significantly if it is made retroactive and business tax relief is added. The philosophy underlying the current Bush tax cut proposal is similar to that of the Reagan economic plan. It is argued that tax cuts are needed to spur economic growth, and steer the economy away from a potential slowdown by putting money in the hands of consumers rather than the government.

While the budgetary underpinnings supporting this tax cut are far more positive than they were in 1981, the Bush tax cut, nonetheless, has the potential to occupy much (if not all) of the available budgetary “space” over the next ten years. Conservative surplus estimates (taking into consideration continuation of popular tax credits and spending programs) peg the amount of the available surplus at \$2.0 trillion to \$2.5 trillion outside of the Medicare and Social Security surpluses. Even if the tax cut is successfully contained at “only” \$1.6 trillion, history suggests that the true cost of this proposal could become much more significant than first projected.

Lessons Learned

The federal budget is a large and ungainly ship which is hard to steer, and harder to turn. In an effort to regain economic momentum and restrain domestic federal spending, President Reagan’s budget strategy plunged the country into significant deficits and accumulating debt. Similarly, in an effort to regain control over the deficit in part to make room for domestic investments, President Clinton unleashed far more robust budgetary surpluses than anticipated.

In both cases (whether related or unrelated to the initial budget proposals), the economy over the two Presidents’ terms, improved significantly. As the attached charts demonstrate, during the 1981-1988 and 1993-2000 timeframes, GDP growth, productivity, unemployment, and inflation all improved. Both presidents also were resoundingly reelected to second terms. However, in both cases, Congress changed parties in part because the initial budget proposals forced tough votes in Congress (immediately in Clinton’s case, later in Reagan’s). An important difference, of course, is that Clinton got the budgetary latitude to make policy choices.

President Bush, who has expressed both tax cutting and spending aspirations (at least in education and defense) may wish to heed the old maxim, “be careful what you wish for,” because in all likelihood he will get it. In achieving its goals now, the new Administration could lose maneuvering room later, particularly if surplus estimates are found to be overstated, or—as happened before—tax reductions overshoot their mark. Once launched, it can be politically costly to make midcourse adjustments to the economic course set in motion. Choices in later years are constrained by decisions made now. Unquestionably, an excess of budget surpluses provides more policy latitude than growing deficits but what’s under discussion again is not “fine-tuning,” and history tells us that big choices launch big effects.

A broader question raised by this review concerns the overall impact that the budget swings are having on the economy and the choices facing the American people. Over the past twenty years, Americans have seen major contractions and expansions of governmental spending and swings in tax rates, resulting in big changes in the government’s fiscal posture. Shouldn’t we be thinking for the future of how to minimize these budgetary shifts and provide greater stability for the nation?

Barbara Chow was a senior domestic policy official with the Clinton White House from 1993 through January, 2001.