Volume Title: American Economic Policy in the 1980s

Volume Author/Editor: Martin Feldstein, ed.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-24093-2

Volume URL: http://www.nber.org/books/feld94-1

Conference Date: October 17-20, 1990

Publication Date: January 1994

Chapter Title: Budget Policy

Chapter Author: James M. Poterba, David Stockman, Charles Schultze

Chapter URL: http://www.nber.org/chapters/c7755

Chapter pages in book: (p. 235 - 292)

4 Budget Policy

1. *James M. Poterba*

Federal Budget Policy in the 1980s

The 1980s began without a hint of extraordinary budget deficits that would emerge later in the decade. In his January 1980 State of the Union message, President Carter labeled deficit reduction his "top budgetary priority." Although his initial fiscal 1981 budget projected a $16 billion deficit, rising inflation in early 1980 coupled with bipartisan pressure for fiscal restraint led President Carter to modify his budget plans. In March 1980, he proposed an anti-inflation fiscal program with a balanced budget.

Five years later, President Reagan proposed a budget with a $180 billion deficit, and actual deficits exceeded $200 billion. His aggressive tax reductions, the military buildup of the early 1980s, and changing economic circumstances combined to produce the largest peacetime deficits in U.S. history. The rapid growth in deficits occurred despite calls for fiscal responsibility and budget balance throughout the decade. Measured as a share of GNP, the federal deficit rose from 2.8 percent in fiscal 1980 to a peak of 6.3 percent for fiscal 1983. To provide some perspective on these deficits, the federal deficit averaged 0.8 percent of GNP in the 1960s and 2.1 percent in the 1970s.

A series of deficit-reduction measures as well as an extraordinary period of economic growth lowered the deficits throughout the latter part of the 1980s. The federal deficit was 2.9 percent of GNP for fiscal 1989, although it increased to 4.1 percent of GNP in fiscal 1990. Much of the late-decade deficit reduction was due to off-budget surpluses in the Social Security Trust Fund. The 1990s opened with renewed uncertainty regarding the future course of

U.S. deficits, as some Social Security reform plans called for payroll tax cuts that would widen federal deficits by as much as 1 percent of GNP per year.

This paper surveys the tumultuous economic history of federal budget policy in the 1980s. It summarizes the central economic trends, quantifies the sources and magnitudes of changes in the federal deficit, and discusses the political forces that supported these developments. The paper is divided into seven sections. The first presents statistical measures of federal deficits and describes the role of tax cuts and spending growth in the widening and then contracting federal deficits of the last decade.

Sections 4.2–4.4 focus on particular policy actions that affected the federal deficit. Section 4.2 concentrates on the Economic Recovery Tax Act of 1981 and the associated spending reductions that composed President Reagan's economic program. The third section analyzes the piecemeal attempts at deficit reduction in the aftermath of the 1981 reforms, notably the revenue-raising tax acts and budget cuts of 1982 and 1984 and the "revenue-neutral" Tax Reform Act of 1986. Section 4.4 examines the Social Security Amendments of 1983, the single most important factor in narrowing the federal deficit during the second half of the 1980s.

Section 4.5 discusses various attempts to reduce or eliminate deficits by altering the budget process. These include the Balanced Budget Amendment, which, while frequently discussed, never achieved political viability, and the various Gramm-Rudman-Hollings deficit limitation bills. Section 4.6 provides a brief discussion of deficit patterns in the late 1980s and the forecasts for the early 1990s. A concluding section distills several lessons in federal budget policy from the experience of the last decade. The final section also summarizes the political trends that accounted for the deficit expansion of the early 1980s and the contraction later in the decade.

4.1 Deficits and Debt in the 1980s

The 1980s were a decade of unprecedented peacetime federal budget deficits, when the federal government borrowed more than $6,000 for each U.S. citizen. This section chronicles the growth and subsequent reduction in federal deficits and provides some historical perspective on these events. In particular, it addresses the relative importance of tax and spending changes in explaining the changing federal deficit.

4.1.1 Changing Federal Deficits

Table 4.1 reports annual federal deficits for the fiscal years between 1970 and 1990, with average deficits for selected earlier time periods. The first three columns present federal outlays, revenues, and the deficit in nominal dollars, while the last three columns report each of these variables as a fraction of gross

Table 4.1 **Federal Receipts, Outlays, and Deficits, 1950–89**

	Billions of Dollars			Percentage of GNP		
Years	Outlays	Receipts	Deficit	Outlays	Receipts	Deficit
1950–59	69.3	67.5	1.8	18.0	17.6	.4
1960–69	129.9	124.2	5.7	19.0	18.2	.8
1970–79	324.2	288.6	35.6	20.5	18.3	2.1
1980–89	882.2	725.8	156.4	23.1	19.0	4.1
1970	195.6	192.8	2.8	19.8	19.5	.3
1971	210.2	187.1	23.0	19.9	17.7	2.2
1972	230.7	207.3	23.4	20.0	18.0	2.0
1973	245.7	230.8	14.9	19.2	18.0	1.2
1974	269.4	263.1	6.1	19.0	18.6	.4
1975	332.3	279.1	53.2	21.8	18.3	3.5
1976	371.8	298.1	73.7	21.9	17.6	4.3
TQ[a]	96.0	81.2	14.7	21.4	18.1	3.3
1977	409.2	355.6	53.6	21.2	18.4	2.8
1978	458.7	399.6	59.2	21.1	18.4	2.7
1979	503.5	463.3	40.2	20.6	18.9	1.6
1980	590.9	517.1	73.8	22.1	19.4	2.8
1981	678.2	599.3	78.9	22.7	20.1	2.6
1982	745.7	617.8	127.9	23.8	19.7	4.1
1983	808.3	600.6	207.8	24.3	18.1	6.3
1984	851.8	666.5	185.3	23.1	18.1	5.0
1985	946.3	734.1	212.3	23.9	18.6	5.4
1986	990.3	769.1	221.2	23.7	18.4	5.3
1987	1,003.8	854.1	149.7	22.7	19.3	3.4
1988	1,064.0	909.0	155.1	22.2	19.0	3.2
1989	1,142.6	990.7	152.0	22.2	19.2	2.9
1990	1,251.9	1,031.5	220.4	23.2	19.1	4.1

Source: OMB, *Budget of the United States Government: Fiscal Year 1991*, historical tables 1.1 and 1.2.

[a] Transition quarter.

national product. In each case, the expenditure statistics reflect actual outlays, not the budget authority amounts that are appropriated by Congress.[1]

Table 4.1 and the associated graph presented in figure 4.1 demonstrate the pronounced expansion of the federal deficit during the 1980s. From an average of 2.1 percent of GNP during the 1970s, the federal deficit grew to 4.1 percent of GNP during the 1980s. The deficit rose most rapidly at the beginning of the 1980s. Between 1980 and 1983, the federal deficit expanded by 3.5 percent of

1. Budget authority is the amount that an agency is authorized to spend; outlays measure actual spending in a given fiscal year. For so-called slow-spending programs, e.g. public housing, it can take five years or more for the sum of outlays to equal budget authority.

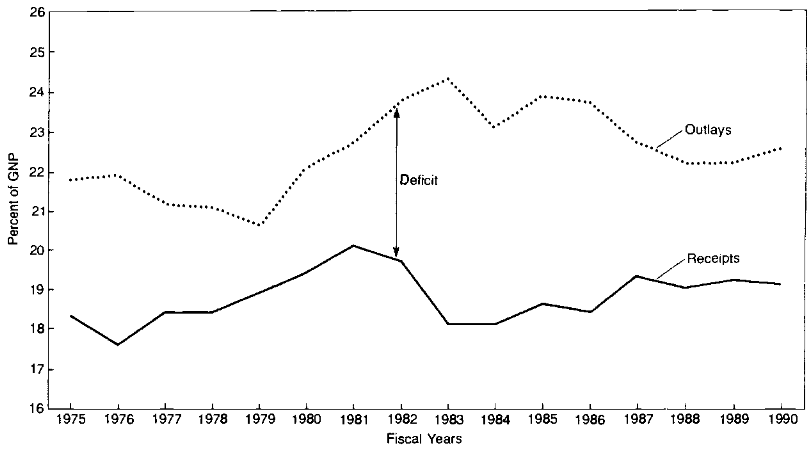

Fig. 4.1 Receipts and outlays of the U.S. government

GNP. This change in the budget deficit was the largest two-year movement since 1969, when the enactment of the federal income surtax reduced the deficit from 3.0 percent in fiscal 1968 to a 0.3 percent surplus in 1969. The deficits of the early 1980s, twice as large as the deficits in all but two other postwar years, are small by comparison to wartime deficits. In 1943, for example, the U.S. federal deficit was 31 percent of GNP.

The second half of the 1980s was characterized by gradual deficit reduction. The federal deficit was only a slightly larger share of GNP at the end of the decade than at the beginning. Federal revenues accounted for 19.4 percent of GNP in 1980, compared with 19.1 percent in fiscal 1990. The similarity of these shares does not reflect the significant changes within the decade, from 20.1 percent in 1981 to 18.1 percent in 1983 and 1984. Similarly, although outlays of 23.2 percent of GNP in 1990 were higher than the 22.1 percent in 1980, this in part reflects the weak economy of 1990. In 1989, outlays were only 22.2 percent of GNP. Moreover, even 1989 outlays are below those in years such as 1983 (24 percent of GNP).

4.1.2 Where Did Deficits Come From?

The information in table 4.1 provides a simple answer to the question of where the deficits came from. Between 1980 and 1983, federal revenues fell by 1.3 percent of GNP, expenditures rose 2.2 percent, and the deficit increased by 3.5 percent. Thus, tax cuts would appear responsible for approximately one-third of the deficit change in the early 1980s.[2] Between 1983 and 1989, as

2. Federal receipts grew by 0.7 percent of GNP between fiscal 1980 and fiscal 1981, and outlays rose 0.6 percent. Relative to a fiscal 1981 benchmark, the tax cuts are therefore more important factors in the deficit increase.

deficits narrowed, outlays fell by 2.1 percent of GNP, while receipts climbed by 1.1 percent, once again suggesting that the expenditure changes were roughly twice as important as tax policy actions.

The changes in federal receipts and outlays are characterized by substantial heterogeneity across revenue source and program type. Table 4.2 disaggregates the two sides of the federal deficit into major tax and expenditure categories for each fiscal year since 1980. The increase in expenditures between the two decades can be traced primarily to an increase in transfer payments to individuals, which includes both direct payments and those channeled through state government, sharp growth in net interest payments due to both increased federal borrowing and higher real interest rates, and an expansion of federal military spending in the early 1980s. Net interest payments were nearly twice as large in the early 1980s, relative to GNP, as in the 1970s; this corresponded to an absolute increase of more than 1.5 percent of GNP. Transfers increased by more than 2 percent of GNP between the 1970s and the first four years of the 1980s. The increase in defense spending is less dramatic; in part owing to the Vietnam conflict, military spending for the 1970s averaged 5.7 percent of GNP, well above the 5.0 percent in fiscal 1980. The Reagan defense buildup raised this spending level by nearly 1.5 percent, to 6.5 percent of GNP, by 1986.

One category of expenditure that is not shown separately in table 4.2, but that has declined during the last decade, is federal spending for nondefense

Table 4.2 **Composition of Federal Outlays and Receipts, Fiscal Years 1980–89**

	1970s	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Outlays											
Military	5.7	5.0	5.3	5.9	6.3	6.2	6.4	6.5	6.4	6.1	5.9
Net interest	1.5	2.0	2.3	2.7	2.7	3.0	3.3	3.3	3.1	3.2	3.3
Payments for individuals	9.2	10.4	10.8	11.4	11.9	10.8	10.8	10.7	10.6	10.4	10.4
Other	4.1	4.7	4.3	3.8	3.4	3.1	3.4	3.2	2.6	2.5	19.6
Total	20.5	22.1	22.7	23.8	24.3	23.1	23.9	23.7	22.7	22.2	22.2
Receipts											
Individual income tax	8.3	9.1	9.6	9.5	8.7	8.1	8.5	8.3	8.9	8.4	8.7
Corporate income tax	2.8	2.4	2.0	1.6	1.1	1.5	1.6	1.5	1.9	2.0	2.0
Social insurance taxes	5.2	5.9	6.1	6.4	6.3	6.5	6.7	6.8	6.8	7.0	7.0
Excise taxes	1.2	.9	1.4	1.2	1.1	1.0	.9	.8	.7	.7	.7
Other receipts	1.0	1.0	1.0	1.1	.9	.9	.9	1.0	.9	.9	.9
Total	18.3	19.4	20.1	19.7	18.1	18.1	18.6	18.4	19.3	19.0	19.2

Source: Data are drawn from OMB, *Budget of the United States Government: Fiscal Year 1991*, A–302, A–287.

Note: Entries are percentages of GNP. The 1970s data for outlays correspond to averages for the period 1971–79; those for revenues correspond to 1970–79.

capital, or "infrastructure." Real net federal investment declined from an average of $16.1 billion (1982 dollars) in the last five years of the 1970s to $11.7 billion in the last five years of the 1980s. As a share of GNP, the decline is even more striking, from 0.5 to 0.3 percent during a ten-year period. This includes some reduction in water and power projects, a decline in community development outlays, and cuts in various other capital programs.

The lower panel of table 4.2 shows receipts and tracks the important rise of social insurance taxes as well as the decline of the corporate income tax. Corporate tax revenues as a share of GNP fell by 1.7 percent between the 1970s and the early 1980s, in part the result of legislative changes and in part because of falling corporate profits.[3] Individual income taxes fell by 1.5 percent of GNP during the first two fiscal years of the Reagan administration. Payroll taxes are the most important growth category with respect to federal receipts. The combined collections from employers and employees increased by more than 1 percent of GNP during the 1980s, and the average of these taxes in GNP was 1.8 percent higher at the end of the decade than in the 1970s. The legislative changes in individual and corporate income tax receipts were due to the various tax reform acts of the 1980s; the payroll tax increase, however, was the result of the 1983 Social Security compromise.

4.1.3 Debt Accumulation in the 1980s

Deficits measure the flow of government spending relative to receipts. The government debt is a stock that equals the accumulation (with interest) of past deficits and that therefore changes only slowly in response to budget deficits. Table 4.3 presents information on the evolution of the federal debt over the last half century. The first column shows the stock of debt, measured in 1989 dollars, at the end of each year. Real privately held federal debt grew from a total of $884 billion (1989 dollars) in 1980 to $1,990 billion at the end of 1989.

A more informative measure of the debt burden is the debt-to-GNP ratio, which is shown in the second column of table 4.3. These entries provide some perspective on the recent debt accumulation: federal debt at the end of 1989 was only one-third as large, relative to GNP, as in 1945. Nevertheless, the debt-to-GNP level rose by 15 percentage points during the 1980s, a far larger increase than that in any other peacetime decade. More important, the accumulation of debt reverses the usual historical pattern of *reduction* in the debt-to-GNP ratio during periods of peace and rapid economic growth.[4]

3. Auerbach and Poterba (1986) show that falling corporate tax revenues are due both to lower corporate profit rates during the 1980s and to the corporate tax reductions in the Economic Recovery Tax Act of 1981.

4. Barro (1986) estimates the relation between debt accumulation and economic conditions from U.S. experience before 1980. His results would have predicted real debt growth of 31 percent during the period 1983–88, when in fact real debt increased by 80 percent. The predictions for 1987–88 would be a 1.7 percent growth of real debt, but the actual growth was 8 percent. Poterba and Summers (1987) provide further detail on these calculations.

Table 4.3 **U.S. Public Debt, 1940–89**

Year	Real Debt ($billions 1989)	Debt/GNP (%)	Real Debt per Capita ($thousands 1989)
1940	387.5	35.9	2.9
1945	1,644.4	105.7	11.7
1950	1,031.0	64.1	6.8
1955	952.2	48.9	5.7
1960	852.4	40.3	4.7
1965	810.5	29.5	4.2
1970	662.0	21.4	3.2
1975	730.5	20.8	3.4
1980	883.9	21.6	3.9
1981	916.7	22.3	4.0
1982	1,065.0	26.4	4.6
1983	1,229.0	28.6	5.2
1984	1,420.0	31.4	6.0
1985	1,612.7	34.4	6.7
1986	1,777.0	37.2	7.3
1987	1,879.0	37.3	7.7
1988	1,899.8	36.5	7.7
1989	1,989.8	37.3	8.0

Source: Debt is interest-bearing privately held U.S. Treasury debt excluding that held by the U.S. government and the Federal Reserve System from the *Federal Reserve Bulletin*. real debt computed using fourth-quarter GNP deflator for each year. Per capita debt computed from fourth-quarter population from the national income and product accounts.

Table 4.3 also reports yet another measure of debt burdens, real federal debt per capita. At the beginning of the 1980s, the government's debt averaged $3,900 (1989 dollars) for each U.S. citizen. By 1989, it had grown to over $8,000. During the 1980s, real per capita government borrowing doubled, and the federal government borrowed the equivalent of $16,000 for each family of four.[5] The burden of repaying this debt will be allocated among future generations by future government fiscal policies.

4.1.4 Caveats Regarding Deficit Measurement

Although the deficit statistics presented in table 4.1 above are the standard basis for budget discussions in both Washington and the media, they are not ideal deficit measures for several reasons.[6] Two important criticisms, that the deficits ignore economic conditions and do not capture the effects of inflation,

5. One introspective test of the effects of government deficits on economic activity is to ask whether households have responded, e.g., by reducing their consumption outlays, in the same fashion that they would have if this debt had been accumulated on personal account. A negative answer suggests that government deficits depress national saving, contrary to the "Ricardian equivalence" doctrine.

6. Eisner (1986) discusses a number of these issues in greater detail.

can be remedied with statistical adjustments. Other difficulties are harder to remedy but may also make reported deficits a misleading fiscal indicator.

The first deficit criticism is that accounting-based deficits do not reflect the influence of changing economic conditions on federal receipts and outlays. Tax receipts rise in periods of strong economic expansion and contract during slack times. Federal outlays, however, *expand* during periods of weak economic activity as payouts for various transfer programs increase. The *full employment deficit,* which describes the net federal deficit or surplus that would be observed if current tax and spending programs remained in force but the economy was at full employment, adjusts reported deficit statistics for cyclical changes by standardizing revenues and outlays to a single point in the business cycle.[7]

The second problem is that standard deficit measures fail to capture the effects of inflation on the government's fiscal position. Federal debt is a nominal liability. Inflation therefore improves the government's real balance sheet by reducing the value of outstanding debt. The *inflation-adjusted deficit* adds a measure of the inflationary gain on nominal government liabilities, including long-term government bonds, Treasury bills, and currency, to the conventional deficit measure.

Table 4.4 presents time-series information on the cycle- and inflation-corrected budget deficits, in each case as a share of GNP.[8] The first column shows the unadjusted deficit as a share of GNP. The second column reports the cycle-corrected deficit. It shows a larger change in the deficit within the 1980s, and a smaller change between the 1970s and the 1980s, than the standard deficit measure. During the 1970s, a decade with a deep recession, the cycle-adjusted deficit averaged 1.6 percent of GNP, compared with 2.7 percent during the 1980s. The unadjusted deficit averaged 1.6 percent of GNP, compared with 2.7 percent during the 1980s. The unadjusted deficits averaged 1.7 and 3.7 percent of GNP, respectively. The full-employment deficit also shows much smaller reduction in deficits between the mid-1980s and the latter part of the decade than the unadjusted data. The unadjusted deficit, in this case measured on the national income and product accounts basis, peaks at 5.2 percent of GNP in 1983 and declines to 2.6 percent of GNP in 1989. The cycle-adjusted series shows a peak of 4.3 percent in 1986, with a smaller decline to 3.7 percent in 1989. This pattern reflects the strong economic expansion of the mid-1980s as well as the weak economic conditions in 1983. Deficit reduction when the

7. Full employment is a convenient base on which to standardize the deficit, but it is not unique. Similar comparative measures of government deficits could be based at other points in the business cycle.

8. Both the unadjusted deficits, in the first column of the table, and the adjusted deficits are measured for *calendar* years, not the fiscal years of standard budget documents, because the cycle-adjusted data are provided from the Commerce Department and are linked to national income and product account (NIPA) data. There are also difference in the accounting conventions used in the NIPAs and in federal budget documents that make it difficult to compare the data in table 4.4 with the budget data in other tables.

Table 4.4 **Federal Deficits Corrected for Cyclical Fluctuations and Inflation**

		Deficit Adjusted for:	
Years	Reported Deficit	Business Cycle	Cycle and Inflation
1950–59	−.1	N.A.	N.A.
1960–69	.3	N.A.	N.A.
1970–79	1.7	1.6	.0
1980–89	3.7	2.7	1.4
1970	1.2	1.6	.4
1971	2.0	2.0	1.3
1972	1.4	1.9	1.2
1973	.4	1.4	−.4
1974	.8	.7	−1.5
1975	4.3	2.6	1.1
1976	3.0	1.8	.7
1977	2.3	1.7	.2
1978	1.3	1.5	−.5
1979	.6	.8	−2.1
1980	2.2	1.3	−1.4
1981	2.1	.8	−1.1
1982	4.6	1.7	.7
1983	5.2	2.6	1.5
1984	4.5	3.4	2.2
1985	4.9	4.2	2.9
1986	4.9	4.3	3.9
1987	3.5	3.5	1.8
1988	2.9	3.6	2.0
1989	2.6	3.7	1.8

Source: The first column is from the national income and product accounts, table 3.2. The cyclically adjusted deficit is from the Bureau of Economic Analysis and is based on a trend GNP series associated with a constant 6 percent unemployment rate. The inflation adjustment multiplies the ex post inflation rate within the year by the stock of government debt outstanding at the end of the previous year.

Note: Figures are given in terms of percentage of GNP. N.A. = not available.

economy is near full employment (as in 1988) does not imply tightening of fiscal stance, and large deficits in a deep recession do not necessarily signal a loose fiscal policy.

The third column of table 4.4 shows the combined effect of inflation and cycle correction. Recognizing the effects of inflation widens the apparent difference in fiscal policy between the 1970s and the 1980s, although it does not fully offset the earlier cyclical correction. In the 1970s, inflation rates were significantly higher than in the 1980s. This implied larger inflationary gains on the federal debt, in effect raising federal receipts. Declining inflation thus lowers the federal government's gain on outstanding liabilities and exacerbates the deficit. Correcting for both the cycle and the role of inflation, the data suggest a shift from approximate budget balance in the 1970s to a deficit of 1.4 percent of GNP in the 1980s.

Although corrections for the business cycle and inflation are the two most common adjustments to reported deficits, one other accounting omission is at least as important. This is the problem of measuring the federal government's implicit liabilities. The savings and loan crisis of the late 1980s illustrates that such implicit liabilities can exert an important influence on the federal fiscal position. Loan guarantees of various kinds, for example, federally guaranteed mortgages through the Federal Housing Administration and the Veterans Administration, Guaranteed Student Loans, and subsidies for export sales through the Commodity Credit Corporation, commit the federal government to make lenders whole in the event of borrower default. Because defaults often occur decades after the loans were guaranteed, the flow of new guarantees is not very helpful in assessing the federal government's loan exposure. In fiscal 1988, the outstanding stock of federally guaranteed debt was $527.8 billion, or nearly one-quarter of the federal debt held by the public.

Proper accounting for implicit liabilities would debit the federal government for the value of the insurance that it provides when a loan is written and subsequently keep track of the changes in the value of outstanding guarantees and consider these as either gains or losses on federal account. The data on default and repayment profiles that are needed to measure the value of insurance have not been well analyzed, however. Thus, while there is a clear consensus that implicit liabilities are a very important part of the federal budget, there is little consensus on how to measure them.

4.2 The Reagan Revolution and Supply-Side Economics

Restraining the growth of government spending and closing the budget deficit were central issues in the 1980 presidential campaign. Republican candidate Ronald Reagan, riding the wave of antigovernment sentiment that had resulted in California's Proposition 13 and touting his record of expenditure cutbacks in California, supported a general rollback in federal spending. The precise nature of his proposals did not become clear, however, until the last few months of the campaign.

Incumbent president Carter adopted various budget policies as the election year unfolded, in part dictated by rapidly worsening U.S. inflation forecasts during 1980. President Carter's initial budget message, in January 1980, called for a $16 billion deficit. When rising inflation rates catalyzed bipartisan support for deficit reduction, however, the president revised his fiscal 1981 budget. His second budget message, in April 1980, called for a $16.5 billion *surplus* in fiscal year 1981 and included 17 billion in new taxes. The most important tax changes were a gasoline conservation tax and a new withholding tax on interest and dividends, neither of which enjoyed widespread congressional support.

The specter of a fiscal 1981 deficit reemerged during congressional budget debate. The House did not approve the president's proposed oil import fee, and Democrats in both houses lobbied for increased spending on social programs. At the same time, rising unemployment lowered federal receipts in fiscal 1980 and suggested a revenue shortfall in 1981. By mid-July 1980, less than four months after President Carter had called for a budget surplus, Treasury Secretary G. William Miller acknowledged (see *New York Times*, 15 July 1980, 1) that the fiscal 1980 deficit could be $60 billion and that the fiscal 1981 deficit was likely to be near $30 billion.

Large and growing federal deficits provided a campaign issue for the Republican presidential candidates. Both George Bush and Ronald Reagan called for spending cuts. Beginning in late June, however, the Reagan campaign also promised substantial tax reduction, along with budget cuts.[9] In part, this reflected Reagan's conversion to various supply-side economic doctrines, such as Arthur Laffer's argument that cutting tax rates could raise revenue and thereby help stem the tide of federal red ink. As the election neared, GOP candidates were pointing to President Carter's 1976 promise to balance the federal budget as a prime example of his unkept promises. During the last two months of the election campaign, the ultimately victorious Republican candidates promised that, if their proposed program cuts and tax reductions were enacted, they would balance the budget by 1983 and deliver a $121 billion *surplus* by 1983.[10]

4.2.1 1981: Tax Cuts and Expenditure Restraint

Ronald Reagan's electoral victory in November 1980, coupled with Republican victories that gave the GOP control of the Senate for the first time since 1954, provided an electoral mandate for the dramatic fiscal experiment that unfolded in the early 1980s. President Reagan's campaign rhetoric described a three-part fiscal agenda: significant tax rate reductions to restore incentives, deep cuts in government entitlements and direct expenditures, and a balanced budget. A countervailing set of promises suggested significant growth in military outlays.

Immediately after Election Day, the new administration began designing policies directed at these three objectives. Just after the election, for example, Edwin Meese announced that President Reagan would issue an executive order calling for 2 percent cutbacks in all federal outlays within a week of taking office. In late 1980, the president-elect's economic advisers, particularly future Office of Management and Budget (OMB) Director David Stockman, began a program-by-program analysis designed to generate a plan of spending cuts.

9. Candidate Reagan proposed a $36 billion tax cut, which would cost 22 billion in fiscal 1981. Details may be found in the *New York Times*, 26 June 1980, 1.

10. Press reports regarding these proposals, such as that in the *New York Times* (10 September 1980, 4), noted, however, the lack of specific plans regarding some reductions in "wasteful expenditures."

After taking office in January, the president began lobbying in earnest for these cuts as well as for a three-year, 25 percent reduction in federal tax rates.

The president's tax and expenditure proposals were nothing short of revolutionary, changing broad trends in recent fiscal policy. An unusual constellation of circumstances gave the proposals a chance of success, however. First, there was broad public dissatisfaction with economic policy. Inflation in 1979 and 1980 had been 13.3 and 12.5 percent, respectively, and the Federal Reserve Board's efforts to squelch inflation had combined with inflationary expectations to drive up interest rates. Unemployment was also rising, from 5.8 percent in 1979 to 7.6 percent in 1981. Although there was no consensus in early 1981 regarding what should be done, there was a consensus that *something* had to be done.

Second, President Reagan's gospel of limited government had received striking affirmation in the November elections. Several liberal Democratic senators, for example, Birch Bayh of Indiana and George McGovern of South Dakota, had been defeated by conservative challengers preaching small government and the supply-side doctrine of lower tax rates. This lesson was not lost on other members of Congress, many of whom feared constituent revolt if they did not deliver a change in economic and fiscal policy.

Finally, President Reagan and his White House staff proved masterful at Capitol Hill political lobbying.[11] On the expenditure side, the administration focused its attention on the omnibus appropriations bill, on the grounds that passing a low enough spending level would force restraint on each of the various speciality committees when they considered their appropriations. With respect to revenues, the president unveiled a tax reform package that promised rate reductions across the board. In this case, fear of constituent reactions to a vote against such a tax bill quieted the opposition to such a tax change and facilitated the administration's lobbying.

President Reagan's February 1981 budget proposal called for a fiscal 1982 tax reduction of $53.9 billion, coupled with spending cuts of $41.4 billion. The proposed deficit was $45 billion (*Congressional Quarterly Weekly Report* [*CQWR*], 21 February 1981, 331). The legislative package that emerged from Congress included smaller spending cuts but followed the broad outline of the president's tax cut proposals. Actual expenditure cutbacks in the omnibus reconciliation bill were estimated to reduce fiscal 1982 outlays by $35.1 billion. House Budget Chairman James Jones described the bill as "clearly the most monumental and historic turnaround in fiscal policy that has ever occurred," and the *CQWR* labeled it "the most abrupt and far-reaching change in . . . federal program directions since the advent of the New Deal" (1 August 1981, 1371).

11. Several examples of the tools of persuasion used by the White House—ranging from presidential telephone calls to agreeing to save particular pet programs from the budget ax—are described in the *Congressional Quarterly Weekly Report* (*CQWR*), 1 August 1981, 1372–3.

Spending cuts fell across a wide range of entitlements and other federal programs. Cutbacks in the Food Stamp Program, Comprehensive Employment and Training Act (CETA) programs, the Energy Department, and many other programs were combined in the legislation. The only program area that was exempt from the stringent budget tightening was defense. From 23.2 percent of the fiscal 1980 budget, military spending rose to 24.9 percent in 1982, 26 percent in 1983, and 26.7 percent in 1984 and 1985. Measured as a share of GNP, defense outlays rose from 5.3 percent in fiscal 1981 to 6.3 percent in 1983 and 6.4 percent in 1985. Budget authority grew even more quickly than these changes in outlays. The difficulty in obtaining the proposed budget cuts, along with the president's clear commitment to higher defense spending, foreshadowed difficulties in future rounds of expenditure reduction.

The president's tax bill also marked a dramatic departure from past policy. The Economic Recovery Tax Act of 1981 (ERTA) called for a 5 percent across-the-board reduction in tax rates in October 1981 and successive 10 percent cuts on 1 July 1982 and 1 July 1983.[12] ERTA reduced the top tax rate on unearned income from 70 to 50 percent, called for inflation indexing of all personal income tax brackets for years after 1985 (a provision not in previous legislative proposals such as Kemp-Roth), and expanded eligibility for tax-favored investment instruments such as Individual Retirement Accounts (IRAs). The bill also changed business taxation, notably by introducing the Accelerated Cost Recovery System (ACRS) of depreciation allowances, which provided significantly greater investment incentives than previous law.[13]

Significant legislative controversy surrounded both the budget and the tax bills. Because the president viewed the tax reduction as a critical part of delivering on his campaign promise to get the government "off the backs" of ordinary households, administration officials were willing to negotiate with legislators, in some cases on a vote-by-vote basis. In many circumstances, the *quid pro quo* for a congressman supporting the tax cut was administration support for an expenditure program that affected the congressman's district. The result was near-complete success in passing the tax reform but more limited achievement regarding spending cuts. More important, there was little prospect for further significant reductions in nondefense spending in later years. Given the administration's commitment to continued growth in defense outlays, tax reductions beyond the fiscal 1982 level were likely to result in high deficits.

A central feature of the 1981 tax reduction was its multiyear phase in, with large outyear tax reductions. Had the first-year tax changes in ERTA taken effect but later changes been scrapped, the deficit for fiscal 1983 would still

12. These provisions bore a strong resemblance to those in the 1977 Kemp-Roth tax proposal, which called for a three-year reduction in average tax rates by approximately 27 percent (10 percent reductions in each of three consecutive years). In part, this reflected Congressman Jack Kemp's central role in designing the Reagan economic program.

13. Fullerton's chapter in this volume provides a more detailed discussion of the tax reform provisions.

Table 4.5 Effects of Tax Law Changes on the Federal Deficit

Year	ERTA (1981)	TEFRA (1982)	DEFRA (1984)	TRA (1986)	OBRA (1987)
1981	−8.9				
1982	−35.6	2.5			
1983	−91.1	16.6			
1984	−136.8	36.0	.9		
1985	−170.3	39.2	9.3		
1986	−209.8	46.7	16.1		
1987	−241.7	56.9	22.0	21.5	
1988	−264.4	57.3	25.4	−8.9	8.6
1989	−290.9	55.7	27.7	−24.4	13.9
1990	−322.8	57.2	31.0	−20.3	16.1
1991	−352.7	61.2	33.8	−16.4	15.7

Source: Entries are reported in current dollars for each fiscal year and are based on estimates as reported in various issues of the OMB's *Budget of the United States Government.* Estimates in the first row are drawn from the fiscal year 1983 budget, those in the second row from the fiscal 1984 budget, etc. The eighth through eleventh rows are all drawn from the fiscal 1990 budget.

Note: Figures are given in terms of billions of current dollars. OBRA (1987) is the Omnibus Budget Reconciliation Act.

have risen as a result of the deteriorating economy and a slowing inflation rate. The actual structure of ERTA, however, placed significant deficit pressure on the budgets for fiscal 1983 and 1984. The tax bills' revenue cuts were exacerbated by the Federal Reserve Board's success in taming inflation. When the tax system is not indexed (even under the 1981 law indexing did not take effect until 1985), inflation inexorably pushes taxpayers with a given real income into higher nominal tax brackets, thereby raising revenue. The revenue effects of a given tax rate reduction are therefore dependent on the rate at which prices and wages are rising.

Table 4.5 shows the estimated effects of the 1981 tax changes on revenues in the fiscal years since 1981.[14] Although the ERTA-induced revenue loss in fiscal 1982 was only $36 billion and that in fiscal 1983 was $91 billion, the estimated effect by 1985 was nearly $170 billion. The links between future tax rate reductions, inflation, and the deficit were clear to sophisticated budget analysts,[15] who began forecasting future deficits of more than $100 billion in the months after passage of the tax reform. These forecasts ignited concerns on Capitol Hill, and particularly in the Senate, that the Reagan fiscal program would be feasible only with somewhat higher revenues.

The deficit projections of both the Congressional Budget Office (CBO) and

14. The estimates assume no behavioral responses to tax changes. If, as Lindsey (1989) e.g., argues, the rate reductions generated a larger tax base, then these estimates overstate the revenue loss.

15. For example, in *The Triumph of Politics,* David Stockman writes that "a 30% rate reduction spread over three years in a 10% inflation per annum economy amounts to a zero reduction in real tax rates. . . . The same 30% tax reduction in an inflationless . . . economy would amount to a 30% reduction in real tax rates. You would therefore need whopping big expenditure cuts to make the budget balance." (1986, 67).

Table 4.6 **Deficit Forecasts by the CBO and the OMB, 1981–85**

		Deficit Projections							
		1981		1982		1983		1984	
Year	Actual Deficit	CBO	OMB	CBO	OMB	CBO	OMB	CBO	OMB
1981	79	48	78						
1982	128	30	46	129	118				
1983	208	−18	23	176	107	210	225		
1984	185	−76	−17	206	97	212	203	203	200
1985	212	−138	−69	226	83	231	205	208	195

Source: Various issues of the OMB's *Budget of the United States Government* and the CBO's *Economic and Budget Outlook.*
Note: Figures are given in terms of billions of current dollars.

Office of Management and Budget (OMB) are shown in table 4.6. In each case, the forecasts are made roughly at the same time as the president's budget message, that is, in January or February. In early 1981, both organizations forecast deficits of less than $50 billion for fiscal 1982. By early 1982, however, the effect of the Reagan economic program and rising unemployment had swelled budget forecasts to $118 billion (OMB) and $129 billion (CBO) for fiscal 1982. While the forecasts agreed reasonably well for the short term, there were substantial differences in the forecasts of long-term deficit prospects. The CBO called for a rising deficit profile reaching $226 billion by 1984, while the OMB, assuming that as-yet-unspecified budget cuts would be enacted in 1982, projected average deficits of just below $100 billion for the period 1983–85. The OMB also assumed more favorable economic conditions than the CBO. In the 1982 projections, for example, the OMB assumed real economic growth of 5.2, 5.0, and 4.7 percent in fiscal 1983, 1984, and 1985, respectively, compared with 4.4, 3.6, and 3.5 percent in the analogous CBO forecasts. By the beginning of 1983, however, both the economic and the budgetary assumptions of the CBO and the OMB were again in reasonable agreement, and each organization reported deficit forecasts of more than $200 billion in *each* of the fiscal years 1983–85.

Early in the Reagan presidency, both the CBO and the OMB underpredicted the fiscal 1983 deficit, while OMB forecasts were well below the 1984 and 1985 deficits as well. Misestimates of future revenues were the single most important factor in these errors, as table 4.7 indicates. The OMB's error in forecasting the fiscal 1983 deficit, $101 billion, consisted of a $65 billion overestimate of revenues and a $36 billion underestimate of outlays. The relative importance of revenue and outlay errors was similar for the OMB's 1984 deficit underestimate. The more accurate CBO forecasts, in contrast, overpredicted revenues by smaller absolute amounts and in some cases (1984 and 1985) actually overpredicted outlays.

Although tax analysts debated the magnitude of the projected deficits by

Table 4.7 Revenue and Expenditure Projection Errors, Early 1982

Forecast Date	1982	1983	1984	1985
1982 OMB forecast:				
Deficit error	10	101	88	129
Revenue error	9	65	57	63
1982 CBO forecast:				
Deficit error	−1	32	−21	−14
Revenue error	13	51	35	29

Source: Author's tabulations based on various issues of the OMB's *Budget of the United States Government* and the CBO's *Economic and Budget Outlook.*

Note: Figures are given in terms of billions of current dollars.

quibbling with some of the OMB's and the CBO's economic assumptions,[16] the central message of the multiyear deficit projections being made in late 1981 and early 1982 was that the 1981 tax and expenditure changes had not solved the deficit problem; if anything, they had exacerbated it. The prospect of $200 billion deficits before the end of President Reagan's first term galvanized congressional Republicans, and some administration officials, to begin searching for further fiscal reforms that would narrow the deficit. This search ushered in the era of piecemeal deficit reduction between 1982 and 1985.

4.3 Piecemeal Deficit Reduction: The Aftermath of ERTA

Supporters of the 1981 tax and spending cuts believed that their new policies would stimulate the economy, eliminating the federal deficit in a few years. The preliminary evidence in the two months after the passage of ERTA did not confirm this. Interest rates were at all-time highs, with the prime rate above 20 percent and mortgage interest rates topping 17 percent. The stock market declined in the month after passage of ERTA, and popular accounts attributed the general financial malaise to expectations of large and rising budget deficits. In an effort to reassure financial markets that runaway deficits would not emerge in the "outyears" of the 1981 tax cut, in the fall of 1981 both Congress and the administration began to consider further spending cuts.

From the administration's perspective, this was an opportunity to consolidate earlier political victories and reduce government outlays. For many in Congress, however, it was an effort to reassess the budgetary priorities of the Reagan economic program and to consider delaying or abandoning the multiyear aspects of the 1981 tax reform.

16. In the early 1982 forecasts, e.g., the CBO assumed higher inflation rates (6.9 percent for fiscal 1983 and 1984 and 6.4 percent for fiscal 1985) than did the OMB (6.0, 4.6 and 4.8 percent, respectively).

4.3.1 The Tax Equity and Financial Responsibility Act of 1982

In September 1981, President Reagan called for fiscal 1982 cutbacks of $13 billion, including a controversial delay in the cost-of-living adjustment for Social Security recipients. He also requested $3 billion of additional tax revenue, although none of the proposed changes involved modifying the basic structure of the 1981 tax act. The administration tax plan was billed largely as a change in tax administration, a tightening of tax enforcement to raise revenue. At the same time, congressional Democrats suggested modifying the recently enacted tax reform bill to avoid major revenue shortfalls.

Budget action in late 1981 was hamstrung by disagreement within the Republican party concerning the appropriate strategy for deficit reduction. OMB Director David Stockman, along with Senate Republicans, favored higher taxes in fiscal 1983 and 1984, while House Republicans (including several ardent followers of supply-side economics, such as Phil Gramm and Jack Kemp), Treasury Secretary Regan, and the president were committed to further expenditure cuts.[17] Although Senate Republicans passed a budget resolution calling for deficit reduction, the House Budget Committee reacted to the lack of White House leadership by deferring any serious budget-cutting initiative until early 1982.

When Congress returned in early 1982 to reconsider the deficit issue, the economy showed clear signs of deep recession. Standard cyclical forces therefore contributed to an expanding federal deficit. In January, President Reagan called for a substantial tax increase for fiscal years 1983–85, including energy taxes and a controversial withholding tax on interest and dividends to improve taxpayer compliance. The Senate Finance Committee followed the administration's lead and, in an unusual departure from standard practice, with tax bills originating in the House, the Finance Committee took the lead in formulating a tax-increase package by attaching a deficit-reduction plan to a minor tax bill that had already cleared the House. The Democrat-controlled House was not willing to initiate a major tax increase in an election year or even to risk constituents isolating their congressman's vote on such a bill. Thus, when the final deficit-reduction bill cleared the Senate, the House voted to send the measure immediately to conference.

The bill that emerged from this unusual legislative process was the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). It called for dividend and interest withholding, rescission of some of the generous asset depreciation provisions of the previous year's tax bill,[18] a stronger individual minimum tax,

17. At the same time, House and Senate conferees were discussing the restoration of the Social Security minimum benefit, which had been eliminated in the Omnibus Reconciliation Act earlier in 1981. This conference, which some hoped would address the broader question of Social Security's financial future, was inconclusive on the broad issues. This set the stage for the Greenspan Commission and the sweeping 1983 Social Security reforms.

18. Changes to capital cost recovery were part of the Senate bill, not that passed by the House, but they were retained in the conference bill.

a faster payment schedule for corporate tax payments, increases in telephone, airport, and cigarette excise taxes, and changes in a variety of intricate corporate tax provisions related to leasing and the accounting for profits in multiyear contracts. The president's budget for fiscal 1984 forecast that TEFRA would raise fiscal 1983 revenues by $17.3 billion and fiscal 1984 revenues by $38.3 billion. By comparison, the same budget estimated that ERTA had reduced revenues in fiscal 1982, 1983, and 1984 by $35.6, $82.6, and $103.3 billion, respectively.

The budget agreement also included a projected $17.5 billion of spending cuts, drawn mainly from new limitations on hospital payments under Medicare. The notable omission from the expenditure reductions was defense. The president's support for expanding the military, coupled with Defense Secretary Weinberger's within–the–White House budgetary politics,[19] protected defense outlays during this period of budget tightening. Early in the Reagan presidency, targets for the growth in defense outlays had been specified in nominal terms. Although the inflation rate by early 1983 was several percent per year below the rate assumed in setting the nominal outlay targets, the secretary of Defense argued for, and largely received, the nominal budget allocations that had been set in 1981. This contributed to rapid expansion of the military budget, with total military spending rising by 1 percent of GNP between fiscal 1981 and fiscal 1983. This is particularly remarkable given the tight fiscal environment throughout this period.

The most important budgetary lesson of the first two years of the Reagan presidency is that it is easier to cut taxes than to cut spending. The difficulty of paring nondefense discretionary outlays, the significant share of the budget that consisted of nondiscretionary outlays, and the president's commitment to a larger military made it extraordinarily difficult to envision expenditure reduction large enough to counterbalance the multiyear tax reduction passed in 1981. TEFRA did reduce federal deficits; the OMB estimates in table 4.5 above suggest revenue gains of between $40 and $50 billion per year. However, this was only a partial offset to the already large and growing federal deficits.

4.3.2 The 1984 Deficit Reduction Act

The eighteen months following the passage of TEFRA were marked by improving economic news, leading some to hope that economic expansion could trim the large deficits then being forecast by the CBO and the OMB, and by a major Social Security reform that is discussed in a later section. There was even some backsliding on deficit reduction: the Interest and Dividends Tax Compliance Act of 1983 extended the deadline for the start of interest and dividend withholding; this was the first stage in a legislative campaign that eventually led to the elimination of his provision.

19. David Stockman (1987) provides a number of examples of Weinberger's tenacious defense of the military budget.

The prospect of an economic miracle eradicating significant deficits had been dashed by early 1984. Consensus forecasts continued to suggest unprecedented budget deficits, and financial markets remained disturbed by the absence of progress in limiting the deficits. This provided the backdrop for President Reagan's call in his 1984 State of the Union address for renewed bipartisan effort to reduce the deficit. In March, the president introduced a plan with the backing of Senate Republicans that for the first time countenanced defense cutbacks, as well as higher taxes, to tame the deficit. The proposal involved cutting defense budget authority by $57 billion from the prior request level and reducing outlays by $40 billion over the fiscal years 1985–87. It also called for an across-the-board freeze on discretionary domestic spending cutbacks in health and farm programs that would reduce spending by $43 billion, and a $48 billion tax increase, although, again, the changes would not affect the individual income tax.

Shortly after the president's budget was sent to Congress, leading administration officials, notably Council of Economic Advisers (CEA) Chairman Martin Feldstein and David Stockman, made it clear that achieving significant progress in deficit reduction would require budget cuts in excess of those proposed by the president. A nontrivial fraction of the Democrat-controlled House sought deficit reduction perhaps twice as large as the "down payment" proposed by the president, in part to underscore the need for higher taxes to finance the ongoing military buildup, and in part to generate larger defense cuts. The congressional Democrats sought to emphasize, at the beginning of an election year, that the Republican economic program had left the federal fiscal house in disarray.

Although motivated by different considerations, support for deficit reduction was clear in both houses of Congress. There were differences nevertheless between Senate and House proposals. The GOP-backed Senate plan called for $45 billion in extra revenues, $30 billion in entitlement cuts, and $41 billion in defense cuts over three fiscal years. The House Democrats' proposal, however, included nearly $50 billion of higher taxes, only $10 billion in entitlement cuts, and $96 billion in defense cutbacks. Both plans promised total deficit reduction ($149 billion in the Senate, $182 billion in the House) well in excess of the initial administration proposals.

The conference committee had difficulty merging the spending cuts of the House and Senate bills and consequently reported a much smaller spending cut then either bill had called for. The resulting legislation, the Deficit Reduction Act of 1984 (DEFRA), called for roughly $50 billion in additional taxes and spending cuts of $13 billion targeted at the health sector once again. The costs of health care to beneficiaries was increased, and the bill also incorporated a fifteen-month freeze on doctors' fees. Defense cutbacks were largely deferred by the conference committee because of substantial differences between the House and the Senate proposals.

Just as the passage of TEFRA had been marked by unusual parliamentary practices, standard budgetary procedures were disregarded in 1984 as both houses of Congress struggled with the deficit-reduction measures. The Senate, for example, debated and passed legislation on deficit reduction before action on the revenue or expenditure targets for the year had been approved. In the House, the reconciliation bill was the vehicle for deficit reduction. It was debated and considered before the appropriate reports from the various committees. In this way, the budget was being determined first by setting the bottom line, then by filling in program totals. Historically, the practice worked in the opposite direction, with each committee appropriating funds for a given purpose and the budget committee then aggregating these requests. The departures from standard practice in both 1982 and 1984 were an important factor in the success of balanced-budget and budget-reform legislation in the next congressional session.

4.3.3 The Tax Reform Act of 1986

By the end of 1984, the sluggish economic growth of the early 1980s had given way to a sustained recovery, with real GNP growth of 1.7 percent in the four quarters ending in December 1984 and 3.0 percent for the period ending in December 1985. The improving economy reduced the urgency for Congress to heed continued calls for deficit reduction from financial markets, and deficit reduction became a less salient economic and political issue.

Ronald Reagan's top priorities in this first term were reducing the growth of federal nondefense spending, along with the taxes to finance it, and restoring U.S. military capabilities. In his second term, the priority shifted to reforming the structure of the federal tax system by lowering marginal tax rates. In early 1984, President Reagan asked the Treasury Department to design a tax overhaul plan. The Treasury's report, which was released shortly after Reagan's overwhelming reelection in November 1984, called for sweeping changes in the structure of tax rates for individuals and corporations. On Capitol Hill, although most tax writers were skeptical of the prospects for a far-reaching reform, there was a sentiment that the era of "loophole closing" revenue bills such as DEFRA and TEFRA had passed. The *CQWR* explained, "A 'cats and dogs' revenue raising bill, like [the] measures enacted in 1982 and 1984 making hundreds of miscellaneous tax changes, will be difficult to pass again. 'There are only big cats and dogs left, and they bite' says John Salmon, Ways and Means Chief Counsel" (27 October 1984, 2787).

In both 1982 and 1984, the rationale for tax reform was raising revenue. The tax reform process that began in late 1984, however, was descended from the flat-tax discussions that had circulated in Washington for nearly a decade. This tax reform debate was different: virtually all the proposed plans were revenue neutral. The nineteen months between the Treasury Department report and the ultimate passage of the Tax Reform Act of 1986 (TRA) involved many of the same curious parliamentary and lobbying practices that had characterized the major budget debates earlier in the decade. When the process concluded with passage of TRA, the outcome (as in 1981) was nothing short of remarkable. The reform represented the single most important change in the U.S. tax code in decades, placed the United States in the vanguard of a worldwide movement toward cutting marginal tax rates, and radically altered the tax disincentive to work at higher incomes.

Despite its important role for tax structure, the 1986 reform was not as important for the course of the federal budget as the tax reforms earlier in the decade. It was not designed to affect the deficit, but most estimates suggest that the TRA did reduce federal revenues. The OMB estimates in table 4.5 above suggest a favorable revenue effect in fiscal 1987, as a result of the transition rules in the new legislation. In subsequent years, however, the TRA generated revenue losses of approximately $20 billion per year. While the precise magnitude of the timing effects from TRA are not clear, their direction is that they helped narrow the deficit in 1987 and contributed to larger deficits in later years.[20]

4.3.4 Summarizing the Effects of Tax Changes

The net effect of the various tax reforms during the first six years of the 1980s, described in table 4.5, indicates that deficits by fiscal 1986 were approximately $150 billion higher than they would have been without these tax changes. The piecemeal reforms of 1982 and 1984 were just that: they did not reverse even half the deficit increase built into the 1981 Economic Recovery Tax Act. Nevertheless, total federal tax revenues do not show this large a decline. Lawrence Lindsey's (1989) study of the tax changes in this period attributes at most half the deficit increase to the effects of tax reform and attributes a significant part of the remaining increase to higher military outlays. The OMB estimates in table 4.5 are not necessarily inconsistent with Lindsey's view, however, because the income tax changes were only part of the tax reform landscape in the early 1980s. The other important feature was the reform of Social Security, which raised payroll taxes and changed the future benefit structure for the federal government's most important transfer program. Although often neglected in federal tax policy discussions, the payroll tax was a critical source of federal revenue growth during the 1980s. Receipts from this tax rose from 6.1 percent of GNP in fiscal 1981 to 6.7 percent in fiscal 1985 to 7.0 percent in fiscal 1990. The next section considers the major changes in the Social Security system during the 1980s, with particular attention to their significance for the federal budget.

4.4 **Social Security and the Federal Deficit**

Federal deficits and the Social Security system are inherently interlinked policies since both transfer resources between generations. Because the central

20. Analyses of how tax changes affect revenues are notoriously difficult because key assumptions about household and firm responses to tax reform are often controversial. The OMB estimates presented here assume *no* behavioral responses. They consequently neglect, e.g., the retiming in capital gain realizations as a result of the Tax Reform Act.

issue of economic concern is the net transfer between generations, not its components such as income taxes, payroll taxes, government spending, or transfers, it is important to consolidate the two in analyzing the government's evolving fiscal position. The budgeting conventions of the late 1980s combined the surplus or deficit from the Social Security Trust Fund, part of the "off-budget" surplus, with the "on-budget" surplus or deficit from other federal operations in calculating the total budget deficit. Trust fund surpluses were a central factor in the apparent improvement in the federal deficit during the late 1980s.

Although there were numerous changes during the 1980s in federal tax and on-budget expenditure policy, there was only one important change in Social Security policy: the Social Security Amendments of 1983. This landmark legislation, however, introduced significant changes in both the financing and the prospective benefits of the Social Security system. One direct consequence of this legislation was that the Social Security Trust Fund ran surpluses, rather than deficits, beginning in 1985 and thereby helped offset the on-budget federal deficit.

4.4.1 The 1983 Social Security Compromise

The 1983 Social Security Amendments are the anomaly of U.S. budgetary history in the 1980s. They combined a tax *increase* and a reduction in the level of government transfer payments, at a time when the tax reductions of 1981 were still being phased in. They also represent an important political compromise, in many ways the most significant such compromise of the decade.

The stage for Social Security reform in the early 1980s was set in the previous decade. Real Social Security benefits increased more than 25 percent in the early 1970s, generating greater program costs. The reduction in labor force activity among the aged, notably the growth of early retirement, also contributed to higher outlays. At roughly the same time, the rate of economic growth slowed, reducing the expansion of the payroll tax base that finances the system. These factors led to a payroll tax increase in 1977, which was viewed at the time as ensuring Social Security's solvency well into the next century. Long-range forecasts regarding the Social Security Trust Fund are necessarily quite uncertain, however. Even by 1980, continued benefit growth in part due to overindexation of benefits for inflation and a sluggish economy led to new forecasts of insolvency.

In May 1981, President Reagan proposed radical changes in the Social Security system, including lower benefits for early retirees and reduced rates of real benefit growth. After two weeks of outcry from various pro–Social Security lobbies such as the American Association of Retired People (AARP), discussion of serious reform was tabled by a Senate resolution promising no precipitous cuts in benefits. Although the administration continued to seek abolition of the $122 Social Security minimum benefit and this provision was included in the 1981 budget conference committee's report, both houses of Congress voted in December to restore the minimum benefit. This illustrated the political difficulty of addressing the Social Security problem: no legislator would survive a reelection campaign if he or she were known as the architect of a Social Security benefit reduction. This suggested that a political compromise on Social Security could not be fashioned through usual legislative channels.

The political stalemate led President Reagan to appoint a fifteen-member National Commission on Social Security Reform, chaired by Alan Greenspan, to study the fiscal problems of the system and propose solutions. The commission was charged to report at the end of December 1982 and, by early December, had reached no consensus on how to proceed. Chairman Greenspan requested a two-week extension of the reporting deadline, however, and during this time worked with small groups of commission members to reach a compromise proposal. This plan, which was announced in mid-January, formed the basis for the 1983 Social Security Amendments.

The Amendments had four central features: (i) acceleration of payroll tax increases scheduled for the late 1980s; (ii) partial taxation of Social Security benefits for elderly households with substantial non–Social Security income; (iii) a six-month postponement of the cost-of-living adjustment originally scheduled for July 1983; and (iv) a gradual increase in the Social Security retirement age from sixty-five to sixty-six in 2007 and sixty-seven in 2027. The third and fourth provision were particularly controversial because they seemed to some to violate the basic spirit of the Social Security program. Senator Claude Pepper, for example, long a champion of Social Security, recognized proposals ii and iii as tantamount to benefit reductions but was unsuccessful in persuading his fellow senators to block the plan.[21]

4.4.2 Deficit Accounting and Social Security

The net effect of these changes is that, for the next twenty-five years, Social Security taxes are projected to exceed benefit outflows and to result in accumulation of a substantial Social Security Trust Fund. In fiscal 1989, Social Security Trust Fund revenues exceeded outlays by $52 billion.[22] This surplus, combined with a deficit of $205 billion from other federal operations, implied a reported deficit of $152 billion. More than half the deficit reduction since 1986, when the combined deficit peaked at $221 billion, is due to the growth of payroll tax receipts. Table 4.8 and figure 4.2 show the net effect of the Social

21. The retirement age changes, although legislated for the distant future, caused substantial changes in the present discounted value of the Social Security transfers to and from different generations. The principal "losers" were those born into, and slightly after, the baby-boom generation. The gainers are the children of the baby boom, who will not be required to finance heavy outlays for their parents' retirement. A systematic treatment of the gains and losses from the 1983 reforms is provided in Pellechio and Goodfellow (1983).

22. The reported off-budget Social Security surplus overstates the excess of taxes over benefits for the trust fund. In 1989, the trust fund tax receipts were $267 billion, while benefit payments were $227 billion. The trust fund also spent $5 billion on administration, so the net surplus, measured as taxes less outlays, was $35 billion. However, the trust fund received $10 billion in net interest payments from the Treasury and collected $12 billion in transfers from other federal agencies.

Table 4.8 **Social Security Surpluses and the Budget Deficit, 1980–89**

Year	Deficit Excluding Social Security	Social Security Surplus	Total Deficit
1980	73	−1	74
1981	74	−5	79
1982	120	−8	128
1983	108	0	108
1984	186	0	185
1985	222	9	212
1986	238	17	221
1987	169	20	150
1988	194	39	155
1989	205	52	152
1990	277	57	220

Source: Congressional Budget Office (1990) and the December 1990 *U.S. Treasury Bulletin.*
Note: Figures are given in terms of billions of current dollars.

Security surplus on federal deficits during the 1980s. The figure demonstrates the central role of the Social Security surpluses in narrowing the federal deficit.

The growing surplus in the Social Security accounts is also the key factor in the narrowing deficits projected for the early 1990s. While the Congressional Budget Office forecasts in July 1990 (see Congressional Budget Office 1990, 36) call for a combined deficit of $146 billion in 1994, this reflects a $255 billion deficit for on-budget federal activities, substantially offset by a $109 billion Social security surplus. The real on-budget deficit, which is not shown in the table, is projected to grow by $6 billion 1989 dollars between fiscal 1989 and fiscal 1994, compared with a projected decline of $32 billion (1989 dollars) in the unified deficit.

4.4.3 The Future of Social Security

The 1983 Social Security reform is important, not just because it altered the federal budget deficit during the latter part of the 1980s, but also because it represented a basic shift in budget policy with respect to transfer payments. Until 1983, the Social Security system operated on a pay-as-you-go (PAYG) basis, with revenues collected solely from the payroll tax used to finance current outlays. The difficulty with this approach, and a central factor behind the 1983 reform, was that maintaining a solvent PAYG system would place high tax burdens on working households in the next century. Aaron, Bosworth, and Burtless (1989) estimate that, to finance Social Security benefits in the next century under a PAYG system, the payroll tax rate would rise from 12.1 percent in 1990 to 16.8 percent in 2040. Including the taxes needed to maintain a PAYG Medicare program, the payroll tax rate in 2040 would be over 23 percent.[23] The decision to raise taxes during the next three decades by enough to

23. This estimate is drawn from Aaron, Bosworth, and Burtless (1989, 51).

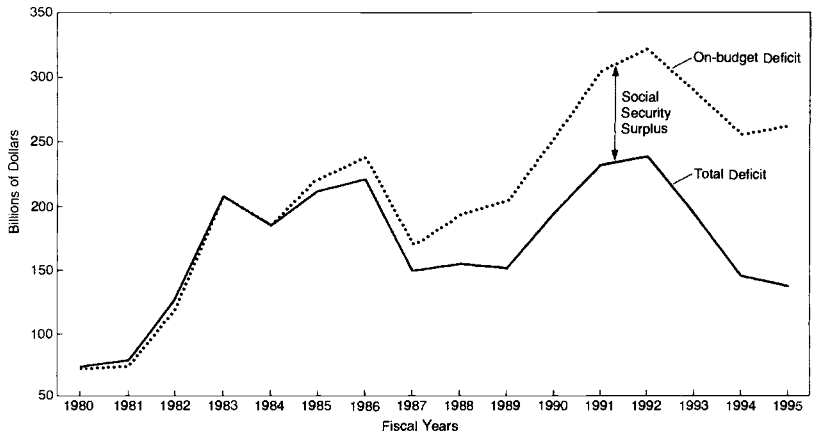

Fig. 4.2 U.S. federal budget deficit

accumulate a significant trust fund surplus is a rare example of a government deciding, in the face of a large future expenditure burden, to raise taxes. As the shape of the Social Security compromise became clear, House Speaker Thomas P. O'Neill, Jr., explained that "we are changing the tradition of this country. In America, each generation has always paid for the generation that has gone before them"(*CQWR*, 12 March 1983, 488).

The 1983 reforms rejected the rising pattern of tax rates implied by this approach as unacceptable fiscal policy. This may reflect a judgment about the appropriateness of large burdens on future generations or a concern among the current work force that such tax rates would never be enacted but rather would be avoided through benefit cutbacks during their retirement. The current policy calls for accumulating a sizable Social Security trust fund in the early part of the next century. Table 4.9 shows the evolution of trust fund assets as a share of GNP during the next century. By 2020, the projections call for assets of $9.4 trillion, or nearly 30 percent of GNP.

The high budget deficits resulting from the economic policies early in the Reagan administration may in some ways have facilitated the Social Security compromise. The apparent inability of Congress and the administration to grapple with the short-run deficits in fiscal 1983–84 may have undermined public confidence in the long-run fiscal health of the Social Security system, making it necessary to take decisive action and discourage any further discussions of potentially bankrupt Social Security system. The general climate of tax reduction in the two years prior to this historic reform may also have contributed to public willingness to accept a set of tax changes that raised payroll taxes and reduced future benefits.

By the end of the 1980s, there were signs that the consensus for using higher payroll taxes to reduce federal budget deficits was eroding. In late December 1989, Senator Moynihan, the chairman of the Senate Finance Subcommittee

Table 4.9 Social Security Trust Fund Accumulation, 1990–2050

Year	Current-Dollar OASDI Trust Fund Assets	Trust Fund Assets/GNP (%)
1990	200	3.7
2000	1,290	12.7
2010	4,490	24.5
2020	9,390	29.7
2030	12,410	22.8
2040	10,680	11.2
2050	780	.5

Source: Hambor (1987, 14).
Note: Trust fund assets are reported in billions of current dollars.

on Social Security, proposed to roll back the increase in the payroll tax that took effect on 1 January 1990 and to continue rollbacks in future years. Supporters of such a proposal cite two arguments. First, the large Social Security surpluses are masking the true magnitude of the federal budget problem, thereby forestalling the needed fundamental action to raise taxes or reduce spending. Although it is difficult to marshall a convincing economic argument along these lines since virtually all the policymakers involved in the deficit process recognize the key role of Social Security, there may be a political justification for such a view. The statistic reported as the budget deficit may have some focal value in attracting the public's attention to the status of fiscal policy. Larger deficit numbers may therefore generate increased pressure for deficit reduction.

The second argument supporting payroll tax reduction is concerned with tax structure. The payroll tax does not tax wage income above a cap level ($51,300 in 1990). It is a flat rate tax, and it is levied on wage but not capital income. These factors make the tax less progressive than the federal income tax. Part of Senator Moynihan's strategy in proposing the Social Security tax reduction was presumably to focus renewed attention on the structure of the entire federal tax system, not simply the income tax, which received a major renovation in 1986. Although at this writing there is little active discussion of the Moynihan proposal, one important lesson of the 1980s is that budgetary politics can change rapidly and in unexpected directions.

4.5 Budget Balance Initiatives

Social Security reform and radical marginal tax rate reductions are the two most lasting fiscal legacies of the 1980s. They were not the most significant reforms to receive active discussion, however. At several junctures, various balanced-budget amendments received serious congressional consideration, although they never received sufficient support to send them to the president for his signature. The Gramm-Rudman deficit targets and the associated reforms in the federal budget process, however, have the potential to influence federal budget policy far into the future.

Beginning in 1982, each Congress considered adopting legislation that would *mandate* balanced budgets. The definition of *balance,* the date when such balance was required, and other provisions varied in the proposals. The two most important initiatives were the 1982 drive for the Balanced Budget Amendment (BBA) to the Constitution and the multiyear budget limitation debate that culminated in the Gramm-Rudman-Hollings legislation in 1986.

4.5.1 The Campaign for a Balanced-Budget Amendment

The most serious discussion of a balanced-budget amendment occurred in early 1982, when previously unthinkable deficits of more than $200 billion were being forecast and there seemed little prospect of achieving adequate spending cuts to balance the budget. In this environment, the notion of a rule that would bind the budget process to yield zero-deficit outcomes attracted a following, although the discussion of precisely how this would occur was always somewhat vague.

The notion of a balanced-budget amendment was not original to the lawmakers of the early 1980s. In September 1978, for example, a bill concerned with the International Monetary Fund was amended to require that annual budget outlays of the federal government could not exceed receipts for fiscal years beginning in 1981, although the bill allowed that the requirement "may be superseded by the action of future Congresses." Congress reaffirmed its attention to balance the fiscal 1981 budget in separate 1980 legislation (see *CQWR,* 12 October 1985, 2038). These strictures were summarily ignored in the actual budgetary process.

There are two ways to amend the Constitution: thirty-four states can pass legislation calling for a constitutional convention, or Congress can pass a proposed amendment and then send it to the states for ratification. Proponents of the BBA operated on both fronts. In January 1982, the Alaska legislature passed a resolution calling for a constitutional convention; it was the thirty-first state to pass such legislation. Simultaneously, Congress considered BBA legislation.

The GOP's Senate victories in 1980, which shifted control of the Senate to the Republican party, were a central factor in advancing the BBA in the early 1980s. The shift made Senator Strom Thurmond of South Carolina, an active supporter of the BBA, the chairman of the Senate Judiciary Committee. Throughout the decade, the Democrat-controlled House was less enthusiastic about budget-limitation measures than the Senate. The BBA debates of 1982 illustrate this.

In August 1982, the Senate passed a balanced-budget amendment by a 69 to 31 margin, two more than the two-thirds majority needed for constitutional amendments. The legislation required Congress to adopt a balanced budget before the start of each fiscal year, although it incorporated limited override provisions for deficits in wartime or if approved by 60 percent of Congress. During the Senate debate on the BBA, proponents fought back amendments to allow overrides related to economic conditions. The legislation thus ran afoul of the standard concern of macroeconomists, that the BBA straitjackets fiscal policy and makes it impossible to use deficit finance to counteract adverse fiscal developments.

Despite support from the White House, the BBA did not pass the House by the required two-thirds majority. House Judiciary Chairman Peter Rodino was strongly opposed to the BBA on the grounds that it introduced matters of economic policy that did not belong in the Constitution into an otherwise legal document. His efforts to bottle up the BBA in committee were overruled, however, when Barber Conable, the chief House sponsor, collected signatures from more than half the House and forced action by the full House. Supporters of the BBA were optimistic about the chances of passage, arguing that, in an election year, it was extremely difficult for any House member to vote against the BBA, and thus for budget deficits, and to explain their action to constituents.

The House Democratic leadership nevertheless worked to defeat the proposal by calling the bill for full House action more quickly than GOP supporters had expected, leaving relatively little time to organize the pro-BBA lobbying effort. The full House voted for the BBA by a 236 to 187 majority, nearly fifty votes short of the necessary two-thirds majority. President Reagan ironically explained that "this vote makes clear who supports a balanced budget and who does not. Voters across America should count heads and take names" (*CQWR,* 2 October 1982, 2420). Although the Senate considered balanced-budget amendment legislation again in early 1985, the measure never achieved the same level of support that it did in 1982.[24]

The debate over the Balanced Budget Amendment highlights one of the paradoxical features of budgetary politics in the United States. Table 4.10 presents data from Gallup polls of the American people at various times during the 1980s, in each case showing that more than half, and, early in the decade, nearly three-fourths, of the population supported a balanced-budget amendment. Support for tax increases, however, rarely exceeded 25 percent, and that for entitlement cuts was rarely above 10 percent. The only program category that the electorate seemed willing to cut was defense, precisely the area where the administration felt its strongest mandate for increased outlays.

4.5.2 The Gramm-Rudman-Hollings Deficit Limitation Measures

Even though the BBA could not command sufficient legislative support for passage, Congress retained a desire to alter the budget process in ways that

24. The administration's budget proposal for fiscal 1984, presented in early 1983, contained an innovative provision for a "trigger tax increase," which would take effect if the deficit exceeded certain targets. Although this provision never became law, it was a precursor to the Gramm-Rudman legislation later in the decade.

Table 4.10 **Gallup Polls on the Federal Budget Deficit**

Date of Poll	Deficit a Very Serious Problem	Deficit Reduction Measures: Support Balanced Budget Amendment	Support Tax Increases	Support Military Cuts	Support Entitlements Cuts
1980 March		75			
1982:					
May		74		43	
November			18	57	12
1983 June		71			
1984 December			23	61	11
1985:					
April	58		18	66	9
August	57		25		
August		54			
November	61		29		
1986 January			22	59	9
1987 July			16	58	9

Source: George Gallup, *The Gallup Poll: Public Opinion* (Wilmington, Del.: Scholarly Resources), various annual editions, 1980–87.

would reduce the chance of future deficits. In late 1985, the Senate took up legislation to raise the federal debt limit from $1.8 trillion to $2.1 trillion. The expansion in debt authority was needed to avoid a federal financial crisis since increased borrowing was required to make federal interest payments. During the debate on the debt ceiling bill, Senators Phil Gramm, Ernest Hollings, and Warren Rudman took the initiative on broad deficit issues and introduced a bill requiring a phased-in program of deficit reduction, leading to budget balance in fiscal 1991. The proponents of Gramm-Rudman-Hollings (GRH) relied on blitzkrieg legislative tactics to advance their bill; the *CQWR* described this as "breach[ing] Congressional custom in a manner not seen since the landmark budget- and tax-cutting bills of 1981" (12 October 1985, 2035). The resulting bill passed the Senate by a wide majority (75 to 24) and led to frustration among Democratic congressmen at the GOP's seizing of the high ground on the deficit problem, which the Republicans had in many ways created.

The Senate GRH bill had two components. The first altered the timing of the federal budget process, accelerating budget discussions and placing deadlines earlier in the calendar year in an effort to permit more deliberation before the start of the fiscal year. The second objective was to introduce a set of deficit targets and a mechanism for ensuring that actual deficits did not exceed them. The key provisions were as follows. (i) The president would be required to submit budgets with forecast deficits no greater than the maximum for a given year. (ii) The OMB and the CBO would prepare estimates of the projected deficit from the enacted budget and tax legislation. (iii) If the average of the CBO and the OMB deficit computations exceeded the maximum allowed, the president would have two weeks to issue a "sequester" order, requiring permanent reductions in budget authority for all outlays other than Social Security, interest on the federal debt, and existing contractual obligations. (iv) Half the sequester cuts would come from entitlement programs with automatic spending increases, such as Medicaid, AFDC, and food stamps, while the other half would come from other discretionary programs. (v) A suspension clause rendered the need for spending cuts inoperative if the economy was in recession, defined as two consecutive quarters of real decline in GNP, or in a war declared by Congress, or whenever a three-fifths majority of Congress voted for such suspension. These provisions represented a total alteration in the ground rules of budgetary politics in the United States.

The Senate took the lead in this round of deficit reduction, but the House also passed a deficit-limitation bill requiring declining deficits in future years and making automatic cuts in nearly half the federal budget if the Congress and the president could not reach a suitable budget agreement. The House Democrats, however, supported tighter deficit targets in 1986, hoping to drive home the magnitude of the budget crisis before the 1986 midterm elections in which twenty-two Republican senators would stand for reelection. The House and Senate versions also differed in the nature of the automatic cuts required if the deficit target was not achieved. The House bill exempted Medicare from mandatory cuts and generally placed more of the cuts on the defense budget than the Senate plan.[25]

After nearly two months of deliberation, in December 1985 a conference committee reached agreement on a compromise deficit-limitation bill, which President Reagan signed. The bill called for a deficit target of $171.9 billion in fiscal 1986, nearly the midpoint of the earlier House and Senate levels, declining to zero by fiscal 1991. The intervening deficit targets are shown in table 4.11. Half the automatic cuts would come from defense and half from nonexempt nonmilitary programs.[26] All programs would have to be cut *by the same percentage;* this limited the president's flexibility, which had been built into the Senate bill. A key provision required the General Accounting Office (GAO) to calculate the average of the OMB and the CBO deficit estimates and transmit an estimate of the needed sequester to the president.

The GAO provision was critical because it was the basis for a constitutional challenge to GRH by Representative Mike Synar. Because Congress can dismiss the head of the GAO, Synar argued that the bill provided executive authority to an organization that was under legislative control. Although GRH included a fall-back provision requiring both houses of Congress to approve the sequester plan and send it to the president, this would negate the all-important inevitability of the budget cuts that the GAO procedure provided. In

25. The House and Senate plans also differed in the nature of the target specified. The House bill required cuts in budget authority, while the Senate targets were set in terms of budget outlays, which meant harsher cuts in programs with long outlay horizons.

26. Exempt programs included AFDC, Medicaid, food stamps, Social Security, and veterans programs.

Table 4.11 Deficit Reduction Targets in Gramm-Rudman I and II

	Gramm-Rudman I	Gramm-Rudman II
1988	108	154
1989	72	146
1990	36	110
1991	0	74
1992	0	38
1993	0	0

Source: Congressional Quarterly Weekly Report (various issues).
Note: Figures are given in terms of billions of current dollars.

July 1986, the Supreme Court found for Synar and declared GRH unconstitutional. Chief Justice Warren Burger wrote that "to permit an officer controlled by the Congress to execute the laws would be, in essence, to permit a Congressional veto." (*CQWR,* 12 July 1986, 1561).

The Supreme Court decision derailed the first Gramm-Rudman-Hollings deficit-limitation plan. A year later, when the Senate was again debating an increase in the debt ceiling, proponents of deficit limits again attached a proposal for gradual deficit elimination to the debt legislation. The key difference between the new legislation, sponsored by Senators Gramm, Chiles, and Domenici but frequently referred to as Gramm-Rudman (hereafter GR), and the previous bill was a final step in the sequester process that required the GAO to submit its report to the OMB, an executive agency. The OMB would review the GAO report, and the president would then issue an order based on it to enforce spending cuts. Many of the other provisions were similar to those in the 1985 legislation, but the deficit targets were loosened from levels in the original legislation to require a deficit of $144 billion in fiscal 1988, declining to zero in fiscal 1993. In addition, the law permitted a $10 billion margin of error in all years until 1993. The intervening deficit targets are shown in table 4.11.

The president signed the new legislation on 29 September 1987, ushering in a new era of deficit politics. The remainder of the 1980s would be marked by various forms of brinksmanship, as Congress tried to force the president to raise taxes or face defense cutbacks and the president tried to force cuts in discretionary programs.

The evidence is still accumulating on the effects of deficit targets. One can debate on a priori grounds whether such targets could ever affect spending outcomes. Since Congress and the president can always agree to modify the targets, they represent a weak form of budgetary restraint. Various budgeting gimmicks, such as the postponement of some expenditures until the first day of the next fiscal year or the acceleration of some receipts, also provide opportunities to reduce the stringency of the effective targets.

There are two reasons, however, for suspecting that deficit targets *do* affect budgetary outcomes. First, they provide a benchmark for budget deliberations, an objective standard against which the president's budget proposal or congressional modifications can be evaluated. Media discussions of whether particular proposals meet the deficit targets appear to "score" different proposals and may encourage frugality by both the president and the legislature. Second, the sequestration procedures through which cutbacks occur enable current legislators to shirk some responsibility for spending reductions, blaming the cuts on the previous Congress that enacted the budget targets. While Congress and the president may opt to circumvent this process if the cuts are too painful, a sequester that is perceived as an equitable reduction in expenditures might be allowed to take effect. In any case, the threat of a painful sequester probably does provide some pressure for budget compromise.[27]

Ultimately, deficit targets cannot avoid the need for fundamental political compromise on the appropriate mix and level of taxes and expenditures. Legislation such as Gramm-Rudman may, however, help focus the process of budget negotiation.

4.6 The Quiet Years: Deficits in the Late 1980s and Early 1990s

After constant change in the first six years of the 1980s, the federal fiscal scene was remarkably calm in the final years of the decade. A period of continuing economic growth helped reduce the federal deficit from 5.3 percent of GNP in 1986 to 2.9 percent of GNP in fiscal 1989. A slowing economy in fiscal 1990, however, combined with growing outlays for the thrift bailout, raised the deficit to 4.1 percent of GNP in fiscal 1990. Roughly one-third of the deficit reduction between 1986 and 1989 occurred through increases in tax receipts, in this case largely the payroll tax, as total federal receipts rose from 18.4 to 19.2 percent of GNP. This growth in receipts occurred largely as a result of economic growth rather than changes in the tax code. At the same time, the level of federal outlays relative to the economy declined from 23.7 percent of GNP to 22.2 percent.

President Bush's campaign promise "No New Taxes" effectively prevented any serious discussion of tax hikes during the first eighteen months of his administration. Just before the midterm elections of 1990, however, the president agreed to renege on this promise. Administration support was crucial to passage of the multiyear deficit-reduction package of 1990, which should lead to several hundred billion dollars of deficit reduction during the first half of the 1990s.

The federal budget process is currently anchored by the deficit-reduction targets in the Balanced Budget Act. These targets are $136 billion for fiscal

27. At this writing, a major test of the workings of the Gramm-Rudman targets is under way. If the targets are suspended on account of military action in the Persian Gulf, the case for their providing an effective break on deficit outlays will be weakened.

1989, followed by $100 billion, $64 billion, and $28 billion for fiscal 1990, 1991, and 1992, respectively. The deficit target for 1993 is *zero,* and the act does not specify targets for subsequent years.

Current forecasts call for continued gradual reduction in federal deficits, in the tradition of the late 1980s. The most widely cited forecasts are provided by the Congressional Budget Office, which assumes that no new spending programs are enacted between now and 1995. A similar assumption is embodied in the CBO's revenue forecasts. Given assumptions about economic growth, however, revenues are allowed to rise as they would if future incomes were taxed according to the current rate schedules. Table 4.12 shows the forecast federal deficit declining from 2.9 percent of GNP in 1989 to 1.8 percent in 1995. Since 1.8 percent is below the forecast growth rate of nominal GNP, these projections imply a declining ratio of debt to GNP during the period 1990–94.

Table 4.12 reports the deficit projections as well as several components of the deficit. The off-budget surplus, primarily the result of payroll taxes in ex-

Table 4.12 Deficit Forecasts, Fiscal Years 1989–95

		Projections					
	Actual 1989	1990	1991	1992	1993	1994	1995
Billions of current dollars							
Revenues	991	1,044	1,123	1,188	1,260	1,337	1,417
Outlays	1,143	1,238	1,355	1,426	1,455	1,483	1,555
Total deficit	152	195	232	239	194	146	138
GRH targets	136	100	64	28	0	...	...
Social Security surplus	52	59	73	83	95	109	124
On-budget deficit	204	254	305	322	289	255	262
Deficit excluding RTC outlays	143	159	162	179	182	177	157
Publicly held debt	2,189	2,378	2,607	2,844	3,038	3,183	3,321
Percentage of GNP							
Revenues	19.2	19.1	19.3	19.1	19.0	19.0	18.9
Outlays	22.2	22.6	23.2	23.0	22.0	21.0	20.7
Total deficit	2.9	3.6	4.0	3.8	2.9	2.1	1.8
Social Security surplus	1.0	1.1	1.3	1.3	1.4	1.5	1.7
On-budget deficit	4.0	4.6	5.2	5.2	4.4	3.6	3.5
Deficit excluding RTC outlays	2.8	2.9	2.8	2.9	2.7	2.5	2.1
Publicly held debt	42.5	43.5	44.7	45.8	45.9	45.1	44.2

Source: Congressional Budget Office (1990).

cess of Social Security outlays, was discussed above. One other important change during this period, however, was the rise of federal outlays to rescue savings and loan institutions. These outlays, which are denoted by the RTC (Resolution Trust Corp.), are also noted in the table. They increase the estimated federal deficit by more than 1 percent of GNP for fiscal years 1991 and 1992 but reduce the deficit in fiscal years beginning with 1994.

The time-varying effect of RTC outlays on federal deficits reflects the nature of these expenditures. Much of the cost of liquidating the thrifts involves working capital, loans that the RTC will take out from the federal government at the beginning of the decade when it takes over assets but will repay later in the decade. Although the interest on such working capital is a real cost from the federal government's perspective, the capital itself is a loan rather than an outlay. The government acquires the assets of thrift institutions in return for extending these loans, so the net effect on the federal balance sheet depends on the net worth of the rescued thrifts, not their gross asset value.

The most appropriate measure of federal deficits for the period 1990–95 is the deficit excluding the noninterest, nonadministrative costs of the RTC. This is shown in the second-to-last row in each panel of table 4.12. The table shows a continuing reduction in federal deficits from 2.8 percent of GNP in 1989 to 2.1 percent in 1995, although the deficits in the early years of the 1990s are well in excess of the deficit targets imposed by Gramm-Rudman. Resolving this disparity is a fundamentally political problem.

4.7 Lessons and Conclusions

The 1980s witnessed more dramatic changes in peacetime federal budget policy than any decade since the Second World War. These changes were the result of major shifts in federal tax and spending policy, reflecting a large military buildup and sweeping reductions in federal taxes. A unique constellation of political forces was needed to prompt such changes.

The experience of the 1980s suggests several preliminary lessons, some of which are not surprising, about the political economy of budget policy. First, it is harder to cut spending and raise taxes than to do the opposite. The central thesis of David Stockman's *The Triumph of Politics* (1986) is that politics eventually prevailed over the ideological zeal of the Reagan reformers. It was more difficult to pare spending than President Reagan had anticipated, but there was widespread support for tax reduction. The Reagan economic program of tax cuts and spending reduction was therefore tilted toward deficit finance from the outset. This was a catalyst to the large budget deficits of the 1980s.

Second, inflation can whipsaw fiscal policy when the tax system is progressive but not indexed. Such a tax system can yield both revenue gains and unexpected revenue shortfalls. The essence of budget balance in the 1970s, a decade of rising federal outlays, was the built-in revenue gains from bracket creep in the federal income tax. When budget forecasts at the beginning of the 1980s counted on the continuation of these gains, however, and the Federal Reserve was unexpectedly successful in curbing inflation, unexpected deficits materialized quickly. With indexation of the federal income tax code in the Tax Reform Act of 1986, the period of significant bracket creep is behind us.

Third, mechanical budget targets may provide a useful focus for fiscal policy debates, but they are unlikely to replace the fundamentally political process of tax and spending negotiation. It is simply not possible, short of a constitutional amendment, for one Congress and administration to commit future legislators or executives to particular actions. This perennial ability to override budget targets, by creating a national emergency or other extenuating circumstances, limits the intrinsic power of balanced-budget rules. Even a constitutional change might fail, as the opportunities to alter accounting rules or other aspects of the budget process might provide latitude for future policymakers. Nevertheless, these rules may focus the budget debate in useful ways, and they can have real effects on budget outcomes. They may also be useful in specifying a benchmark set of budget cuts that can form the basis for debate and discussion. If the prespecified cuts are perceived as fair and equitable, they may set the stage for similar outcomes in budget negotiations.

Fourth, the off-budget outlays and implicit liabilities that economists have long warned are a central part of the federal deficit picture have emerged as controversial topics of policy debate. The Social Security Trust Fund and the Resolution Trust Corporation are at the heart of the policy debates regarding deficit policy at the beginning of the 1990s. Phantom attempts to achieve deficit targets by camouflaging spending as loan guarantees, by instituting tax policies that yield short-term revenue gains but long-term losses, and by invoking accounting tricks to balance one budget at the expense of the next only make the problem of budgetary balance more difficult. Real progress in deficit control requires political consensus to live with tax levels that are commensurate with expenditure demand. One lesson that the 1980s have not taught is how this can be achieved.

References

Aaron, H. J., B. P. Bosworth, and G. Burtless. 1989. *Can America afford to grow old?* Washington, D.C.: Brookings.

Auerbach, A. J., and J. M. Poterba. 1986. Why have corporate taxes declined? In *Tax policy and the economy*, vol. 1, ed. L. Summers. Cambridge, Mass.: MIT Press.

Barro, R. 1986. The behavior of United States deficits. In *The American business cycle: Continuity and change*, ed. R. J. Gordon. Chicago: University of Chicago Press.

Congressional Budget Office. 1990. *The economic and budget outlook: Fiscal years 1991–1995: An update*. Wasington, D.C., July.

Eisner, R. 1986. *How real is the federal deficit?* New York: Free Press.

Hambor, John C. 1987. Economic policy, intergenerational equity, and the Social Security Trust Fund buildup. *Social Security Bulletin* 50 (October): 13–18.
Lindsey, L. B. 1989. *The growth experiment*. New York: Basic.
Pellechio, A., and G. Goodfellow. 1983. Individual gains and losses from Social Security before and after the 1983 amendments. *Cato Journal* 3 (Fall): 417–42.
Poterba, J. M., and L. H. Summers. 1987. Finite lifetimes and the effects of budget deficits on national saving. *Journal of Monetary Economics* 20 (September): 369–92.
Stockman, D. A. 1986. *The triumph of politics*. New York: Harper & Row.

2. *David Stockman*

It occurred to me that to address the topic of budget policy in the 1980s is to be reminded of the words of Gandhi, when he was asked what he thought about Western civilization: "It would be a good idea," replied he.

Well, budget policy in the 1980s would have been a good idea too. But instead what we got was $1.5 trillion worth of cumulative deficits, radical deterioration of our internal and external financial health, and a political system that became so impaired, damaged, fatigued, and bloodied by coping with it year after year that it now functions like the parliament of a banana republic.

Now, my point of departure is that, for the thirty prior postwar period years leading to 1980, there was no real hint that this kind of fiscal carnage was possible in the American political system. Deficits tended to average about 1–2 percent of GNP. They ebbed and flowed with short-term economic and political cycles, and policy was relentlessly incrementalist in the sense that Senator Long invoked earlier when he said, "I voted for the ITC six times, three times for it and three agin." Policy continuously oscillated in a narrow channel, resulting in long-run fiscal equilibrium over three decades.

The contrasting radical breakdown in the 1980s will doubtless spawn decades of academic diagnosis, but, as a thoroughly biased, and therefore unreliable, participant, let me offer a four-point theory of what I think happened. The breakdown came in about four equal doses. One was a huge case of mistaken belief by the GOP in terms of its attitudes toward domestic spending (or toward what for shorthand purposes I'll designate in the rest of this presentation as its attitudes toward the welfare state). The second part of this breakdown was ideological mischief begotten by the supply-siders, particularly as they shaped and sized the original package.

The third part of the breakdown I would describe as a one-time, sixty-day breakdown in the normal partisan checks and balances of the fiscal process that led to the tax bidding war in June 1981, the auctioning off of a massive chunk of the revenue base in July, and the consequent 7 percent of GNP "hole in the budget" that became the defining condition of the 1980s.

The fourth part of the equation I would call the *steel wool effect* of a Madisonian (divided, fragmented) constitutional system. When major, polarizing domestic policy action is discretionary (e.g., national health insurance), the Madisonian system is conservative (i.e., it delays action and wears down the activist proponents). But, where such mega–policy actions are necessary and unavoidable (as in the 1980s budget breakdown), it generates an escalating level of friction and frustration. In the context of the 1980s deficit saga, it thus had the effect of rubbing raw, injuring, and debilitating the two political parties as they struggled year after year with the near impossible task of assembling majorities for the allocation and distribution of fiscal pain that was orders of magnitude larger than could be coped with in a single sitting or act of governance. Consequently, the fixing of this giant budget hole became a multiact ordeal that generated an accumulating level of mistrust, conflict, and demoralization within the system that paralyzes the process still today.

To understand these four factors, I found it useful to dial in on them through the lens of my ex-mentor (or, I should say, one of my ex-mentors since it seems I've had a fair number over the years) John Anderson and his penultimate question as an independent presidential candidate in 1980. "How could you slash taxes, pump up defense, and balance the budget all at the same time?" His answer was, "With mirrors." In hindsight, it seems that he was right. But I believe that that would be too easy and too ahistorical an explanation for the 1980s fiscal breakdown, one that ignores much of the important flavor and moods of early 1981 that actually shaped this process.

The reason that sane adults even entertained the Reagan macro budget proposition was that, until it was designed, sized, and executed into law, as a matter of mood, preference, and policy direction, it sounded right to much of the newly ascendant Republican government. So we introduce factor number one. The Republican party had become self-intoxicated by decades of its own chicken-dinner speeches and fulminations against big government. By 1981, it therefore had a willingness to believe that substantial blocks of domestic outlays could be excised from the budget and therefore that spending reduction would compose a viable part of a big sweeping change in the fiscal equation. Now, I will not dwell here on any war stories but just offer three facts and an obvious interpretation.

The facts have to do with the great center block of the budget, and I call this *the old people's budget* and *the poor people's budget.* The former consists of Social Security, Medicare, and the related retirement programs, the latter of AFDC, food stamps, Medicaid, the other means-tested income transfer programs, and a few social service programs.

Here are the three facts. First, in the early 1960s, the combination of the poor people's budget and the old people's budget cost 4 percent of GNP. Second, on the eve of this 1981 change in policy, the old people's budget and the poor people's budget cost 10 percent of GNP (1980). So, in a sense, in the intervening two decades there had been a series of policy decisions to allocate 6 percent of GNP away from the productive population of the country toward the old and poor, a policy decision that was obviously valid for a democratic government to make if it wished.

My third fact is that by 1986, after the Reagan revolution was all over except for the shouting, the old people's budget and the poor people's budget cost precisely 10 percent of GNP, exactly the same as it cost in 1980. There was no net change, just some minor reallocations on the margin from the poor to the old.

The meaning is that, after six years on the wrestling mat of big, real, painful fiscal choices, as opposed to twenty years on the chicken circuit of costless rhetoric, the Republican party, collectively, got up from the mat, dusted itself off, ran to the opposite corner, and embraced the status quo in the big fiscal center block programs—lock, stock, and barrel. This outcome of validating the domestic center block of the budget obviously destroyed the whole Reagan fiscal equation, period. But I think that the interesting question is why, in the heat of real-time politics, the Republican party collectively ate its rhetorical hymnbook, so to speak. Well, by 1984–85, I didn't really have much to do any more, so I undertook an exhaustive study, brick by brick, of the political process by which this 6 percent reallocation in the center block—from 4 to 10 percent of GNP to the old people's budget and the poor people's budget—had occurred over the preceding twenty years. The result, I think, was quite interesting.

Most of that reallocation occurred in the old people's budget, as you can imagine, and, in fact, it was the result of thirteen major legislative acts between the late 1950s and the late 1970s. So I analyzed the voting record on these major acts—Medicare, Medicaid, the 1972 Social Security Amendments, the expansion of disability insurance, and so forth. Collectively over the period, the Republican vote in the Senate on these thirteen major acts was 90 percent yes, 10 percent no. The House Republicans were a little more conservative—the collective vote over the twenty-one-year period was 80 percent yes, 20 percent no. In short, the Republican party had been the coarchitects over the previous twenty years of this massive and permanent change in the center block of the domestic budget. Now that was on the social insurance or old people's budget side.

If you look at the record on the poor people's budget, it was even more interesting. In 1962, all these programs that are included in this heading cost $15 billion (in 1986 dollars). By 1980, they had increased nearly eightfold to $112 billion, and that was the other piece of the center block that had to be confronted when the new policy was put into place. I thought that it would be interesting to see when this growth had occurred—a $100 billion change from $15 billion to $112 billion over those eighteen years—and here are the answers. Of this growth, $16 billion occurred during the big spending wave of the Carter administration and $27 billion during the runaway spending period of Kennedy-Johnson, leaving a mere $54 billion, or well over half, to have occurred in the Nixon-Ford watch.

So again, the Republican party, both as to the administrations and as to the ranking members of most of the relevant committees of jurisdiction in the House and the Senate, had been coarchitects of the other piece of the center block.

I think that this is significant because, in 1980, the entire remainder of the budget, other than this 10 percent old people's and poor people's budget, was 13.2 percent of GNP, and interest and defense were 7 percent. Thus, there was 6 percent left for all other domestic programs. And, of that 6 percent, most of it consisted either of what all of us would agree were legitimate functions of government, such as lighthouses or the FBI, or of what I would call the discretionary pocket change that is necessary to lubricate a political democracy.

As a matter of fact, if you look at that 6 percent residual and just take one major piece, the agriculture, veterans, education, transportation, public works, and local economic development programs at 1986 prices, you will find the following. Under the Carter or pre-Reagan policy that was in effect in January 1981, had these policies and programs remained unchanged, they would have cost $150 billion (in consistent 1986 budget prices). In 1986, when the Reagan "cutting" was all over, the Reagan actual policy—when the dollars were totaled up at the end of 1986 for the same set of agriculture, veterans, education, transportation, and public works program—was not $150 billion; it was $140 billion. So, in these programs, partisan differences as to funding and policy over the period 1981–86 were microscopic.

Now, I'm not trying to gainsay $10 billion in budget savings. That was not easy to get. But, from a fiscal policy viewpoint, when you have knocked a $200 billion hole in the revenue side of the equation, also at 1986 prices, a $10 billion spending cut in the secondary part of the budget and no change in the center block are really not a lot to write home about.

This is apparently what the public wanted, so I'm not reciting all this to moralize or even condemn the special interest groups. In fact, I think that the result was a legitimate referendum, in a sense, on all these programs year after year, as they were set up, debated, and left mostly intact in the legislative process. My point is that part of the reason that we set off down what turned out to be an imprudent course in 1980 was that the Republican party at that moment in time was suffering from a kind of cumulative, cognitive dissonance about "runaway spending" that in early 1981 gave an implausible fiscal equation and air of plausibility.

The second factor, the ideological mischief, I can cover very quickly. And here I'm not arguing with the content of the supply-side economics because it was pretty obvious and unobjectionable. But I do take issue with its militant rejection of incrementalism as an approach to policy, the militant rejection of one-year-at-a-time fine-tuning and its attempted replacement with radical multiyear structural change in the major revenue, defense, and domestic components of the budget.

The problem with radical, structural, multiyear change was that it required the policy process to undertake an impossible act. And that was to forecast this massive hunk of GNP called the U.S. economy that floats around in an open world financial system three to five years into the distant future with some precision. This, of course, gets us to "Rosy Scenario," the most fabulous forecasting error in human history, in which, for the relevant period in which these sweeping changes were being made, fiscal 1982–86, we overpredicted GNP by the precise sum of $2.145 trillion. Now, that was cumulative, but, on a final year basis, 1986, it meant that the forecast of money GNP was $660 billion higher than what actually turned out. Now, you remember that, in a pre-Reagan unindexed tax system, we took in about 30 percent of the marginal dollar of money GNP in revenue. So, when we overpriced the GNP by $660 billion, we overestimated the revenue base by over $200 billion. This had two effects. First, it gave the illusion, as this architecture was being constructed, that we were cutting prospective surpluses, and that didn't seem like such a dangerous thing.

Second, the administration was not alone in the $2.1 trillion massive overshoot of where the outyear GNP and revenue base would be. The far more realistic and sober Congressional Budget Office (CBO) forecast of March 1981—and they had a month more to think about this—overestimated the five-year GNP by only $1.7 trillion rather than $2 trillion. But the effect on the revenue base of all this massive overforecasting of long-run money GNP was basically to disconnect the alarm systems in the political and fiscal process and lead to a course of events that should not have happened.

Specifically, if you go back to Rosy Scenario and price out the pre-Reagan tax policy to 1986—and this is in the documents from February 1981—you will see that, under that forecast of the GNP, the projected "old law" tax take was going to be 24 percent of GNP. Then, if you priced out the pure proposed Reagan tax cuts, 10–10–10 and 10–5–3, it was going to reduce the tax base by 4.5 percent of GNP. Twenty-four minus 4.5 was going to get you to 19.5 percent—when it was all done. And a 19.5 percent tax take was, in turn, the golden mean of the previous thirty years of fiscal history in the United States. So the outcome as then projected, with these faulty views of the future, was not crazy but more or less in line with where we had been.

My point here is that, if you do some reverse fiscal engineering, and take the world that actually occurred, and look backward and price out the pre-Reagan tax policy from a 1986 vantage point looking back—because the money GNP was massively lower (as to both output and prices)—the pre-Reagan policy generated less than 22 percent of GNP in taxes in the world that actually occurred. If you then expanded the tax cut that resulted from the bidding war that we discussed, from 4.5 to nearly 6 percent of GNP, you ended up, not at the gold mean (19.5 percent), but with a outyear revenue base by fiscal year 1986 that amounted to 16.9 percent of GNP, the lowest level since 1939!

Then, if you bump the spending side, which had been about 20 percent over the postwar period, by 1 percent for defense (a little that we were going to restore), and if you add to that a 2 percent bump in interest expense as these massive deficits materialize, both actually and prospectively, you end up with a budget equation in which the outlay side is locked at 24 percent and the revenue side at 17 percent. There was a 7 percent "hole" that became the whole history thereafter.

The third factor was how the bidding war got so out of hand. Well, I think that the fatal act probably occurred on 12 January 1981, if you want to be precise. On that particular night, there was a meeting of what we then euphemistically called the "College of Cardinals." Those were the long-standing, middle-of-the-road, incrementalist Republican leaders—Senators Howard Baker, Peter Domenici, Mark Hatfield, and Bob Dole, Representative Bob Michel, and so forth—who basically had great fears and uneasiness about the whole plan. They couldn't quantify it, but they knew in their bones that radical multi-year tax cuts were a dangerous thing. As a matter of fact, because of that, 10–10–10 didn't have a snowball's chance.

It was in this context that a major, once-in-a-decade kind of political bargain was struck in Senator Baker's library. It was agreed that supply-side was the right policy direction: the marginal rates were too high, the economy needed supply-side stimulus, but—and here is the key point—the *size of the tax cut* would have to be earned by the prior enactment of a *multiyear spending cut package*. Once the latter was done, then we would see how much tax cut we could afford. Would it be a 15 percent, a 20 percent, or a 25 percent rate cut? The size of the spending cut success would drive the shape of the executed tax plan, as opposed to the paper document.

Now again, this seemed utterly plausible. I heartily embraced that formula myself and sold it in the White House because I was only a half-breed supply-sider anyway. The other half was kind of recidivist Hooverite.

Now, this sensible formula led to a derailment in May 1981, in my judgment, when, against all odds, the Gramm-Latta or White House Republican Dixiecrat version of the spending cut piece, the first proposition, which had to be shaped and sized, passed the House despite the Democrats having a majority. This had two powerful effects. First, it further anesthetized the "College of Cardinals" as to the incipient fiscal dangers. The experience of real budget cutting was novel and alien—after all, they had been distributing goodies for twenty years. What was recorded by the CBO as $35 billion in cuts felt politically to them like it was $50 billion or $100 billion, so bruised and battered were they when the smoke cleared on the budget resolutions and reconciliation bills. In fact, the permanent cut turned out to be less than $20 billion (after it could all be measured a few years later). Some of it was pure legerdemain at the time, such as taking SPRO (the Strategic Petroleum Reserve) off budget, a big $3 billion savings, and a lot of it got incrementally repealed and put back into the budget in a process of hostage taking over the next three or four years. We couldn't and didn't know at the time that the rule of multiyear budgeting is that, for every dollar you cut, at best sixty cents is permanently saved.

So my point is that what felt like a $50 billion cut politically ended up a $20 billion cut in reality—not very much, but it came at the crucial moment in late May when we were about ready to launch the tax process. The feeling of accomplishment on the budget-cutting package became a vast exaggeration of reality mainly because the legislative experience had been so jarring and so traumatic. Consequently, the guard came down even further among the "College of Cardinals."

The second consequence was that the House Democrats lost control of the House on something really important for the first time in twenty-seven years. In fact, they had been crushed and humiliated in a political sense. And, as we went into the next phase of this logical process—spending first, size the tax cut, do the latter later—the Democrats turned out to have one and only one objective in mind, and that was recouping their manhood and political power in the House. Thus, on the crucial date of 4 June, when the choice came down to bipartisan compromise or an auction on the tax bill, both sides were brittle, recalcitrant, and breathing partisan fire. The irony is that, once the auction route was chosen, rather than compromise, the congressional Democrats spent the next thirty days savaging the tax code, which was totally against their long-run interest, and then spent the thirty days of July passing out hundreds of billions in tax goodies to Republican interest groups, which, in retrospect, was nothing short of insane.

This leads to my fourth point. There we were with a 7 percent of GNP hole in the budget, spending at 24 percent, revenue at 17 percent, and there was only one thing to do—spend the next decade raising taxes and restoring and replenishing the revenue base, since there was no spending left to cut, as history subsequently proved. Now, for the next thirty months (after August 1981), the restoration of the revenue base turned out to be a quite heroic chapter in U.S. history. The center of both parties rallied to the unpleasant job of raising taxes. Almost everyone in the White House joined in the work of tax raising, except for the guys who wore the Adam Smith ties and, unfortunately, the guy who had to sign the tax bills. But, in any event, over this thirty-month period, we passed the Tax Equity and Fiscal Responsibility Act (TEFRA); something like $50 billion in revenue replenishment in the outyears; a Social Security tax bill that had a lot of revenue, direct and indirect, in it, including the upper income recapture of taxes; the Deficit Reduction Act (DEFRA) in 1984; and so forth.

By July 1984, we had replenished the revenue base on a 1986 price basis, back to 19.5 percent of GNP, the golden mean, where we had started way back in 1980. But then, the 22 percent policy spending level that was built into the budget had ballooned to 24 percent because of the accumulating interest, and we still had a huge hole. Moreover, Mr. Madison's contraption, the constitutional system that absolutely frustrates the assembly of governing majorities, had taken its toll.

From a conservative viewpoint, the great virtue of our system is that it prevents governments from acting and therefore prevents a great deal of mischief. And that is OK under ordinary conditions of balance. But we needed majorities to rectify a massive, artificial imbalance, and, in a sense, the political process became impaled on the mechanism.

As a result, there was only one way to get these year-after-year tax bills through the labyrinth of our process, and that was a combination of browbeating and furious wheeling and dealing. But after two and a half years of forced march back up the unpleasant political hill of tax raising, the collective system was seething with grievances, bruises, irritations, and a sense of huge unfairness because much of what had been done at the policy level on tax restoration had absolutely no rhyme or reason. The justification for most of it was that we had to put something in the collection plate, and we did whatever was possible.

Now, in this context, after July 1984, the system went into full paralysis owing to one blunder and one big lie. The first blunder was obviously Mondale and his error of speaking the truth out loud in public early in the campaign in 1984. But what compounded and put the system into paralysis from that point forward was a second factor, what I call the *big lie:* the last destructive act of the supply-siders before they faded into the dustbin of history.

In about July 1984, they convinced Meese and the president that they had been badly double-crossed in the "three-for-one" spending and tax-raising deal in the 1982 TEFRA. This claim is not even debatable. It was a blatant lie. But it split the Republican party into two camps, with one camp under Mr. Vladimir Ilyich Gingrich [a reference to Representative Newt Gingrich], leading the Republican backbench true believers off on a partisan stab-in-the-back campaign that had nothing to do with reality.

But, in any event, over the next five years, the Democratic tax raisers that the system needed went deep into their bunkers, while Gingrichites, posing as the fiscal equivalent of Whittaker Chambers, stood outside the door with their antitax M-16s at the ready. Now, in my judgment, incalculable damage was done by these fiscal gunslingers because the entire remainder of this long business expansion of five years was squandered and the remainder of the problem didn't get fixed.

As the draftsman and the accountant for the three-to-one deal that gave rise to the "big lie" and the ultimate paralysis and the fix that we are in today, I would like to conclude by setting the record straight. There was \$300 billion in multiyear spending cuts planned against \$100 billion in tax increases. But, of the \$300 billion, \$100 billion of that was debt service savings, half legitimate and half a little artifact or expedient that was manufactured at the time. A debt service savings of \$50 billion would occur if you closed the policy gap by raising revenues or cutting spending—it was legitimate.

The other \$50 billion was a result of a convention adopted in the bipartisan negotiating process that, if we were to make this fundamental change in course and fix this huge gap, interest rates would drop 2 percent over a period of time, and the deficit would be $50 billion lower.

Now, by the time we got to 1984, the latter had already occurred and would continue to occur over the remainder of the three or four years. The supply-siders chose not to count that fact. Much of the other $50 billion also occurred because most of the policy changes were actually made. That's the first $100 billion: most of the debt service savings actually occurred. The next $50 billion was "management savings." That could not possibly have happened because, on a full-year, fully effective basis, it would have required firing one of every two non–Department of Defense civilian employees in the federal government—and, at that particular time, we were fighting drug wars and crime wars and a lot of other things, and we needed more people rather than fewer. That $50 billion did not happen, but it got put in the package because it had been in the administration's January 1982 budget—and had been invented twelve hours before the printing deadline to avoid sending the first $100 billion deficit recommendation in history to Congress. And that had occurred, in turn, because, at the last minute, the president and Meese had gotten religion from the Chamber of Commerce and dropped a $50 billion package of excise tax increases.

The third $50 billion was defense. Every dime of this happened, except Cap Weinberger did not want to count it or acknowledge it, so therefore it was believed by the White House that that part of the spending deal had been lost as well.

The next $70 billion of that cut consisted of discretionary domestic appropriated programs that were supposed to be cut over a three-year period. Most of this did not occur, but one of the reasons was that every single appropriations bill from TEFRA through the 1984 campaign was *signed* by the president because the White House believed that it might not be good for the reelection campaign not to sign. As a consequence, that $70 billion probably didn't happen, but it didn't want to happen in terms of the posture that the White House took on all the bills.

The other tiny remainder was $30 billion in entitlements cuts, of which $19 billion was actually enacted. So, if you go through all this, you end up with $11 billion slippage of the $300 billion target. Not bad. And it seems to me that to call this some grave stab in the back is indeed nothing less than a "big lie."

From that point forward, the Democrats were in the bunkers, and backbenchers from the Republican party in the House were on the outside, so we had paralysis, in effect, for five years. I think that, in this whole sad chapter, there is a positive outcome here. It ended on 14 June 1990, when Bush finally moved his lips. I think it constituted the first step in the Republican return to adulthood as far as fiscal policy matters are concerned. Undoubtedly, there will be some misfires along the way. But, with both parties out of the bunkers or the closet on the fundamental problem of restoring the tax base, rational discourse was once again recommenced, a process of adult negotiation is slowly resuming, and, over a period of a few years in my judgment, the remaining correction will eventually be made.

The 1980s fiscal breakdown, therefore, constitutes a detour in history. It does not require any change in the process. It does not say that there's a fundamental disease in our political democracy. It says that there were a series of accidents and incidents that were unfortunate but that are now, even as we meet here, in the process of being remedied.

3. *Charles Schultze*

After listening to David Stockman, I don't know where to start. He already said many of the same things I was prepared to say, and with greater insider's knowledge. It appears that a recidivist Stevensonian and a recidivist Hooverite interpret the same facts the same way.

The letter of invitation suggested that I give my impressions of what drove policy decisions during the 1980s, what options were chosen, and why certain policies were followed rather than others. But, while it may surprise and amaze you, I was not consulted very much by the Reagan policymakers. What inside information I do have comes from reading the same leaks in the *Post*, the *Times*, and the *Wall Street Journal* and from the memoirs to which all of you have had access, spiced only occasionally by a few tidbits of gossip from friends on the Hill. I decided, therefore, to concentrate primarily on an attempt to put the 1980s budget policy into a historical and institutional context. By coincidence, this also happens to provide additional background and further support for some of Dave Stockman's observations.

In stark outline, my major thesis is simple. The American political system has tremendous inertia. It is terribly hard to get things done. And the budget-making component of that political system shares the inertia. Contrary to popular myth and public choice theory, the budget system does not have a bias that tends routinely to produce excessively large expenditures, taxes, or deficits. One characteristic of an inertial political system like ours, however, is that, while it is very hard to make a big mistake, once you make a large one, the inertia also works against correcting it. And 1981 was one big mistake! Since 1982 we have been fighting the inertia. This systemic problem was compounded by the particular beliefs of two presidents. The first one believed that, next to nuclear war, the worst thing that could ever happen to a country was a tax increase (and he wasn't quite sure about the ranking). The second one, at least up until 14 June 1990, appeared to have inherited a paler version of the same belief.

Let me fill in a little of this outline. The American political system of divided powers shares with the Japanese and the Swiss the characteristic that it takes a large degree of consensus to get anything substantial done, compared to other major industrial countries, whose parliamentary systems can move much more rapidly and without the need for as wide a consensus. In fact, the inertia of our system is usually a virtue. The great majority of what elected officials, and often a majority of the population, would like to do in the first flush of enthusiasm is almost always wrong. It is not a coincidence that the United States and Japan have by far the lowest share of government spending in GNP among the major industrial countries. From table 4.13, you can see that government spending in the United States and Japan is 10–30 percent lower than in other countries. If we exclude defense, the Untied States is lower than Japan. And the U.S. growth in the government spending share over the past fifteen to twenty years has been the lowest of all the other countries.

The political and institutional inertia that I noted above clearly applies to the budget process. Contrary to the public choice literature, it is a myth that the democratic majoritarian process of making budgets through congressional processes biases the government toward spending too much and borrowing excessively to do so. Table 4.14 provides additional evidence. It divides the budget into two parts: (i) outlays and revenues of the Social Security Trust Fund (including hospital insurance) and (ii) everything else, which for simplicity let's call "the general operating budget." The postwar years were indeed marked by a very large increase in Social Security expenditures and revenues relative to

Table 4.13 **Six Countries' Government Spending as a Share of GNP, Selected Years, 1965–86[a] (%)**

	1965	1970	1980	1986
United States				
Total	27.8	32.2	34.1	37.2
Excluding defense	20.7	24.9	28.8	30.5
Japan				
Total	19.1	19.1	32.1	33.0
Excluding defense	N.A.	18.3	31.2	32.1
France				
Total	N.A.	44.5	47.0	52.9
Excluding defense	N.A.	41.2	43.7	49.7
Germany				
Total	36.9	39.0	48.8	47.2
Excluding defense	N.A.	36.1	46.0	44.5
Sweden				
Total	N.A.	43.7	62.0	64.9
Excluding defense	N.A.	40.4	58.9	62.3
United Kingdom				
Total	35.9	39.5	45.2	46.0
Excluding defense	N.A.	N.A.	40.3	41.2

Note: N.A. = Not available.
[a]All levels of government.

Table 4.14 **Budget Outlays and Revenues as a Share of GNP, Fiscal Years, 1955–90 (%)**

Budget Components	1955	1960	1965	1970	1975	1980	1985	1990
Total budget[a]								
Outlays	17.7	18.2	17.6	19.8	21.8	22.1	23.9	21.9
Revenues	16.9	18.3	17.4	19.5	18.3	19.4	18.6	19.6
Of which:								
Social Security[b]								
Outlays	1.1	2.2	2.5	3.5	4.7	5.3	5.9	5.7
Revenues	1.4	2.1	2.6	4.2	5.1	5.3	6.2	7.2
General operating								
Outlays	16.7	16.2	15.2	16.5	17.4	17.0	18.2	16.8
Revenues	15.6	16.3	14.9	15.6	13.5	14.2	12.7	12.9

[a]Total outlays and revenues are smaller than the sum of the two components because intrafund transactions such as payments from the general fund to the Social Security fund are netted out in the total.

[b]Includes outlays and revenues of the old age and survivors, disability, and hospital insurance trust funds.

the size of the economy and, of course, far in excess of what would have been required simply by a maturing of the system in effect forty years ago. But, rightly or wrongly, wisely or unwisely, the American people have overwhelmingly approved this expansion and have been willing to pay the full tax burden of supporting the system. Look, for example, at public acceptance of the changes legislated in 1983. Voters did not rebel against the bipartisan decision to adopt a payroll tax schedule sufficient to begin accumulating substantial surpluses in the fund. The Social Security and Medicare system is overwhelmingly popular, and its expansion appears to reflect pretty accurately the will of the electorate rather than some defect in the political system à la public choice theory.

Social Security and Medicare apart, the general operating budget of the federal government, as shown in table 4.14, has remained a virtually stable share of GNP since at least 1955 (the major exception, ironically, being the large increase in the first five years of the Reagan administration). Similarly, the share of general revenues in GNP did not rise in the postwar years: indeed, it fell.

If you now look at table 4.15 you can see that, within the totals of the general operating budget, there appears to be another rule of thumb that governs long-run budget outcomes—the share of GNP taken by civilian program spending rises to absorb any major decreases in the defense share but does not rise in the absence of such defense reductions. In particular, sustained rises in the civilian budget share were not financed through tax increases or deficits. Even when the unexpected occurred—for example, large increases in Part B of Medicare and in Medicaid over their projected levels—the response was to

Table 4.15 **Federal Government General Operating Outlays as a Share of GNP, Selected Fiscal Years, 1955–90 (%)**

Category	1955	1960	1965	1970	1975	1980	1985	1990
Total	16.7	16.2	15.2	16.5	17.4	17.0	18.2	16.8
Defense	11.1	9.5	7.5	8.3	5.7	5.0	6.4	5.4
Nondefense	5.6	6.7	7.7	8.2	11.7	12.0	11.8	11.3
Net interest	1.4	1.5	1.4	1.6	1.8	2.1	3.4	3.7
Civilian programs	4.2	5.2	6.3	6.6	9.9	9.9	8.4	7.6

squeeze these overruns out of the other spending. The application of this general rule by Congress and the administration kept the total operating budget at a roughly constant percentage of GNP.

The popular view that Congress traditionally tended to outspend presidentially requested budgets is principally a myth. In a 1985 article, Paul Peterson analyzed appropriation requests and enactments (including supplementals) from 1947 through 1984. He found that, over the thirty-eight years, the Congress, on average, *cut* $800 million from the president's budget requests. Interestingly, the Congress increased defense appropriations on average while cutting civilian by enough to achieve an overall reduction.

Peterson notes some limitations to his conclusions. Conceivably, the Congress might have spent a lot more, had it not been for the threat of a presidential veto. The Congress does have a nice habit of initiating new projects, and, once projects are started, presidents feel obliged to request appropriations to complete them. Water resource projects are a good case in point.

The Peterson analysis does not include entitlements. But it is far from obvious how that omission affects the conclusion. For example, as Peterson pointed out, the Congress turned down both Nixon and Carter's welfare reform programs, and, as I noted above, it forced the rest of the budget to eat Medicaid and supplemental medical insurance (SMI) overruns. So, despite some qualifications, I think the conclusion stands. In the aggregate, Congress did not increase the president's budget, at least not by enough to make any macroeconomic difference.

There is also the popular view that, in the absence of an indexed tax system before 1985, the bracket creep caused by nominal GNP growth produced a continuing rise in the average effective rate of the personal income tax, which the Congress then spent. That is also a myth. Periodically, those revenues were given back in tax cuts. Indeed, if anything, the tax cuts were somewhat too generous. As you can see, going back to table 4.14, general revenues as a share of GNP actually declined slightly over the thirty-five years prior to 1980 and would show a long-run decline even if we had corrected for the recessions of 1975 and 1981. The average effective tax rates of the federal personal income tax fluctuated closely around a mean of 10 percent of personal income from 1947 to 1980. From 1976 to 1980, it averaged a little above that, at 10.5 percent. But, in essence, the average personal income tax rate did not drift upward as alleged; potential creep was offset by periodic rate cuts. Now, clearly, the country was due for another rate cut in 1980 because the average rate had begun to move up. And, within the long-term stability of the average rate, the marginal rate had risen. But, about the magnitude of the 1981 tax cut, one can only apply the remark alleged to have been made by John Jacob Astor, standing in the lounge of the Titanic when ice from the iceberg began cascading on deck: "Bartender, I know I asked for ice, but this is ridiculous!"

In sum, prior to the 1980s the United States had a political and budget-making system under which there had been a large, and apparently quite popular, parallel expansion in Social Security outlays and revenues but that had been quite effective in holding all other budget outlays to a remarkably stable and, by international standards at least, modest fraction of the nation's GNP. Adjusted for the business cycle, budget deficits were seldom a major problem. From a macroeconomic standpoint, the budget process was quite workable. There were micro problems that we all know about, problems that existed then and have continued: pork barrel allocation of projects, parochialism, and unwillingness to call a halt to projects that prove wanting. But, in the aggregate, the system has been quite successful in keeping a lid on the fraction of the economy claimed by the government. The sins of the budget and of the Congress were mainly micro sins, not macro sins.

In 1981, that macro inertia was broken through by the Reagan revolution. And, as David Stockman so nicely put it, the largest impact came in the first two months—the 1981 tax cut, combined with the launching of a massive four-year buildup in defense spending. The root of the error was not simply a bad forecast within the limits of the optimism typically displayed by those proposing policy changes. I have in my files a March 1981 Treasury release, outlining all the great things that were going to happen were the tax cut realized. What it promised was that gross private domestic investment, as a share of GNP, would rise from 15.7 percent to 19.9 percent over the next five years. The share (measured in current dollars) actually remained constant until 1986, and then fell, to less than 15 percent. The release projected that business fixed investment would rise from 11.5 to 15 percent and promised other aspects of performance well outside the range of historical experience. (Mind you, this was not the initial rosy scenario; this was the result after Murray Wiedenbaum and other people had cut back the even more ambitious promises of the initial projections.) The essential mistake was the reliance on the absolutely unwarranted hype of supply-side ideologues rather than on the failure to achieve a reasonable target for budget-cutting.

Once the mistake had been made—in response to an unusually charismatic president with a large electoral margin—the inertia of the system worked against correcting the mistake. And, as I said, the inertia was coupled with the fact of having had two presidents who were adamantly opposed to the tax increase needed to deal with the problem.

Let me make one final set of comments about the budget history of the 1980s. If you look at table 4.15 again, you will see that the 1980s did succeed in reducing significantly the GNP share of civilian spending programs (outside Social Security). As a share of GNP, that spending was reduced from 9.9 percent of GNP in 1980 to 7.6 in 1990, a drop of 2.3 percentage points. A small part of the drop may be due to the fact that 1980 was a year of minirecession, but the decline adjusted for that fact is still some 2 percentage points. About 60 percent of that decline in the civilian spending share was achieved by huge cuts in a limited number of programs. I had thought until recently that the cuts in the share of civilian spending in GNP were principally the result of penny-pinching everywhere with little selectivity. But, as can be seen in table 4.16, there were indeed some very substantial selective cuts in programs that we might label the "losers." And, of the 2 percentage point reduction in the share of non–Social Security civilian spending in GNP, about 60 percent came from these losers. A number of large programs were, if not eliminated, virtually eliminated or cut back very substantially.

Some may look at these data and conclude that, at least in one respect, the Reagan revolution and the large deficits it produced were successful; they forced the inertial system into sharp reductions in low-priority programs. So, you might conclude, we got something for the deficits, even if the revolution did not deliver on its other promises. But think again. Look back at table 4.15. You will notice that interest on the public debt expanded to fill two-thirds of the decline in civilian operating programs. Not all of that expansion in interest payments was directly and indirectly due to the deficits, but a large fraction was. So, to the extent that the large deficits can be seen as a strategy, forcing a decline in civilian spending, it was an incredibly expensive one. It ended up replacing program spending, the benefits of which may indeed have been smaller than its costs, with interest payments on the debt, which provide no benefits whatsoever.

Table 4.16 Major "Losers" in the Budget

	1980	1990
Total losers[a]	1.5	.3
Total "losers"[b]	63.4	13.8
Energy (excluding R&D)	10.9	.1
Community and regional development	17.8	6.4
Training and employment	16.2	5.3
General revenue sharing	13.6	1.8
International financial programs	3.8	−.3
Education and training of health care workers	1.1	.5

[a]Percentage of GNP.
[b]Billions of 1992 dollars.

Summary of Discussion

Martin Feldstein initiated the discussion by describing how nondefense discretionary spending by the federal government has changed over time. This category of spending, which excludes Social Security and other entitlement programs, grew steadily as a share of national output over several decades and reached almost 6 percent of GNP in 1980. But the trend was sharply reversed during the Reagan administration, and, by the mid-1980s, this type of spending had fallen to less than 4 percent of GNP. In light of this turnaround, Feldstein thought that Stockman had understated his achievements as budget director when he said that it had been impossible to achieve significant spending reductions.

Feldstein wondered what had changed in public attitudes and in the Congress that had made such a dramatic shift politically acceptable. It was not, he believed, a fear of budget deficits because the spending reductions had begun with the Gramm-Latta law, which predated the rise in the deficit.

David Stockman disagreed with Feldstein's interpretation of the spending numbers. He argued that it was not appropriate just to compare overall spending before and during the Reagan administration. Rather, the appropriate comparison was between actual spending under the Reagan administration and an estimate of how much pre-Reagan policies would have cost in that same year. He gave one example of such a comparison—the cost of a large set of programs that included almost everything in the discretionary budget was \$150 billion in 1980 and \$140 billion, adjusted for inflation, in 1986. This was clearly not a big decline.

Stockman also said that a few programs had been introduced in 1979 and 1980 that had temporarily ballooned 1980 spending. These included countercyclical assistance through general revenue sharing, a large public service jobs program, and a surge of research funded by the Energy Department. Because these programs were not part of the "settled, long-standing consensus" about domestic spending, they were easily excised in the 1981 budget and did not reemerge. Although Stockman thought that it had been important to eliminate these temporary items, this should not obscure the fact that the core of domestic spending—the items he had termed the "old people's and poor people's" budget—had not been reduced in the 1980s.

Michael Mussa disagreed, saying that political pressures had in fact produced significant changes in spending during the 1980s. He said that one could always *claim* that the increases in spending on Social Security and Medicare and other programs in the 1960s and 1970s were a permanent part of the budget, while the programs that had been enacted later in the 1970s were temporary because they had been scheduled to disappear. But it seemed to Mussa that one could prove almost anything with that sort of analysis. He argued that, if one looked carefully at programs for the poor and at many discretionary components of spending, there had been very substantial cuts in those programs as a share of GNP and that there had been substantial pain associated with the cuts.

Two large programs had not been restrained in the 1980s, however. First, it had proved to be impossible to alter Social Security substantially. The Democrats had fought any change, and President Reagan and the Republicans had decided not to pay the political cost of addressing the issue. Second, Medicare was taking an exploding share of the budget, although the need to reduce the budget deficit had finally resulted in pressure on doctors and hospitals to contain that spending. Mussa believed that this action might augur future attempts to decrease the contribution of the working-age population in support of the elderly population.

Mussa added that every president for over twenty years had campaigned on a platform of reducing government spending. Although it is politically very hard to cut spending, it is also politically hard to raise taxes, so it is difficult to know how large a government the public truly wants.

Feldstein stressed Mussa's point that the "temporary" spending of the later 1970s could easily have become a permanent part of the budget. Further, whenever temporary spending programs had expired in the past, new programs had been introduced that continued the overall increases in discretionary spending.

Stockman argued that there had been no reason for discretionary spending to continue growing in the 1980s. In particular, the caseloads of most discretionary programs were not growing, so there was no reason that this spending should have grown in absolute terms and maintained its share of GNP. The appropriate measure of policy change is whether the absolute dollars being spent in 1980 changed in real terms by 1986. And the answer is not very much. Stockman also emphasized his view that there are no significant reductions in domestic spending that anybody in Congress would even talk about now in public, much less vote for. He had knocked on many doors of tiny and obscure programs over eight years, and even the Republicans did not want to cut any of them. In the recent budget package, the only domestic spending reductions were based on "beating up on the doctors," which is just a game because they raise the expected prices under Medicare every year before cutting them.

Feldstein reiterated that one could look at any five-year historical period and say that there was no reason for discretionary spending to have increased, but it had consistently increased anyway.

Stockman repeated his view that the chief source of growth in nondefense spending from 1960 to 1980 was in the "old people's budget and the poor people's budget." Even apart from Social Security, the big growth was in Medicare and Medicaid. Stockman said that Schultze's table 4.16 showed all the significant spending reductions in the 1980s, and they were in a very limited list of programs amounting to about 1.5 percent of GNP.

Charles Schultze added that he believed that the administration had reduced spending by an additional 1 percent of GNP by "penny-pinching" in other programs, meaning that the growth in spending was held to inflation or a little less while the real economy was growing.

Schultze then returned to Feldstein's opening comment that a fear of deficits had not been the driving force in reducing spending. Schultze believed that, to the contrary, the existence of huge budget deficits for eight years had prevented even the big spenders in Congress from calling for new programs or additional spending. This had been a bad way to reduce spending because the resulting deficits meant that the country simply spent more now on interest.

Feldstein asked Stockman to comment on the theory that the administration had deliberately created large deficits in order to apply the pressure on spending of which Schultze had spoken.

Stockman said that the theory is not correct and is not supported by the evidence. First, the "rosy scenario" that had projected shrinking deficits under the administration's budget plan had been publicly debated for months before the plan was enacted. Second, Congress had not based its actions on the administration's rosy scenario but had used the Congressional Budget Office (CBO) forecast instead. So it was ridiculous to argue that the administration's plan had been pushed through Congress "by stealth." Stockman did not think that anybody had had the idea that they were creating a huge deficit that would be a great disciplining mechanism for Congress; he agreed with Schultze, however, that the 1981 fiscal changes did have that effect.

Stockman also reiterated his view that there had been no fundamental change in public or congressional attitudes about the core of government spending. He said that the spending numbers overwhelmingly proved this point.

Feldstein asked Schultze whether he knew why the CBO had aided and abetted the rosy scenario. *Schultze* responded that it is human nature in that kind of job not to fly too much against the proposals of a popular president. One comes to believe that there is something to the proposals, and one does not want to lose credibility by opposing them entirely. *Feldstein* noted that a large part of the error in projecting the deficit was due to an inflation forecast that was actually too *pessimistic*. The forecasters greatly overestimated nominal GNP, and thus tax revenue, because nobody believed that the Fed was going to bring inflation down so quickly.

Stockman added that nobody in government ever predicts a recession, although *Rudolph Penner* said that the CBO had predicted a recession for 1979 and that, because they had been wrong at the time, they were more reluctant to be pessimistic in the early 1980s. *Feldstein* said that the Council of Economic Advisers (CEA) had projected a 1 percent GNP growth rate for the first quarter of 1983 because they did not want to forecast negative growth and one was the smallest integer. Then the recovery began, and the "true supply-siders" disparaged the "gloom and doomers" in the CEA for not appreciating the economy's true growth potential.

Schultze described five theories that had evolved in support of the tax cuts of the early 1980s. The first was a pure supply-side theory: the economic growth that would result from a substantial reduction in taxes will not make up the lost revenue entirely but will come close. In other words, the country could "grow out of" the deficit. Schultze recalled that, as a presidential candidate, Ronald Reagan had once said that the country could finance the defense buildup with the extra revenue gained from the tax cuts. The second theory, of which Stockman had spoken, was that spending could be reduced to match the lower tax revenue. The third theory, introduced when the first two did not work, was that deficits do not matter anyway. Then the fourth theory was that, even if deficits did matter, they were still very useful in holding down spending. At some point, President Reagan had said that the way to reduce your kids' spending is to give them a smaller allowance—and Congress was the kids. And the final theory was that, even if the other four theories are not right, the deficits are less harmful than the tax increases that would be necessary to eliminate them.

James Poterba noted another feature of budget policy in the early 1980s, which was that, despite the burgeoning deficits, there had also been a growth in political support for various kinds of budget-balancing initiatives. The Balanced Budget Amendment probably reached its highest level of support in 1982, and, although it was not approved by Congress, the country did end up with the Gramm-Rudman law in its various forms, institutionalizing a form of budgetary brinksmanship that the country was still living through.

Poterba wondered what set of political expectations had generated this support for balanced budget rules. Was it a view that the government would not actually follow through on the budget targets being enacted? Was it a view that the government would at some point substantially reduce spending? Or was it a reluctant recognition even in the early 1980s that the government would at some point need to undo the big tax cuts and that this was just a way of precommiting to do so?

Penner said that he had been fairly involved in the drafting of the Gramm-Rudman law and that it had clearly been a bipartisan initiative. Penner did not discuss the Republicans' motivations for supporting the law, but he said that the Democrats had believed that the law "was a wonderful device for smoking out the president" and forcing him to raise taxes in order to protect his defense buildup. Unfortunately, as it turned out, the president was quite willing to sacrifice defense programs in order to avoid major tax increases. In any case, it proved to be quite easy to cheat on the law so that the targets would not be binding, and, on those rare occasions that they had been binding, of course they were changed.

On a broader issue, Penner expressed his disagreement with Stockman's view that there was no fundamental problem with the U.S. budget process. He believed that it had been easier in the past to make big changes in the direction of fiscal restraint because the political leadership had had much more influence over their followers. When Eisenhower was embarrassed by a $13 billion deficit, there was a shift in fiscal policy between 1959 and 1960 that was three times as big as the changes embodied in the recent budget agreement. The Vietnam surtax package was four times as big as the recent budget agreement when measured by the change in the full employment surplus. But, today, each member of Congress is an individual entrepreneur, and it is very hard to get the members to agree on anything. Penner could not imagine a Representative Newt Gingrich thwarting his president in the past without having some horrible sanction applied against him.

Charls Walker strongly supported Penner's comments and believed that Schultze and Stockman had been much too optimistic in their presentations. Walker said that the United States has become more and more of a plebiscite democracy, where the members respond very quickly to what the public wants. But the public today seems to be either schizoid or wily because they have sent people to Congress to support spending and then elected a conservative president to restrain that spending. Walker believed that this type of divided government had worked in the past because of strong congressional leadership but that the rise in congressional entrepreneurship that Penner described had made divided government unworkable today. Walker concluded that the president should be given more authority in the budget process than simply sending a budget up to Congress and being forced either to accept the final bill or to veto it and stop the government.

William Niskanen described two notions of fiscal responsibility, only one of which he said had been raised so far in the discussion. The notion on the table was that the government should build a revenue base that supports the level of spending that the politicians seem to want. The alternative notion is that the government should reduce spending to the level of taxes that voters seem prepared to support. Niskanen remembered Stockman as an aggressive and maybe naive younger man who had thought that the responsibility of the Office of Management and Budget was to cut spending to the level of taxes that people are willing to pay. Stockman's comments at the conference were saddening because he seemed to have switched to the view that the only responsible fiscal behavior is to increase revenues to match the current level of spending.

Niskanen believed that there are two important fiscal facts. One is that voters clearly react against increases in taxes. He had studied a century of presidential elections, and, even prior to the New Deal, increases in taxes reduce the percentage of the popular vote for the candidate of the incumbent party. Economist Sam Peltzman had recently completed a much more comprehensive analysis of senatorial elections, congressional elections, and gubernatorial elections, and the evidence is overwhelming that people have consistently voted against the candidate from the party that has raised taxes. All the voting data imply that voters do not believe that marginal spending is worth as much as the taxes that pay for it. The second important fiscal fact, faced by the budget director and by everyone in the executive branch, is that it is difficult to cut spending.

But which of these fiscal realities should be taken as given? The clear signals coming from the electorate or the difficulties faced by conscientious, hard-working budget directors like Stockman in persuading the Congress to cut spending? Niskanen believed that there is a massive agency problem in the U.S. political system, in which political representatives who favor high spending are elected and reelected even though the voters have been sending a consistent signal for at least a hundred years about the size of the government they want.

Stockman responded that Niskanen had raised the fundamental question in deciding whether institutional reform is needed in the national budget process. Does the permanent and rigid consensus about spending reflect the political machinations of elected officials, or does it reflect the views of an electorate that is saying that it wants most of these programs? Stockman believed that there is no case for the existence of an agency problem. When politicians refused, time after time, to reduce spending on Social Security, Medicare, and related social insurance programs, it was clear that "this was the public speaking through the voice of fear-ridden elected officials." And "it was the public speaking when the most conservative president likely to be elected in modern history" vowed in a debate with Democratic presidential candidate Walter Mondale that he would never touch Social Security. Stockman believed that the same public consensus holds for the current programs designed to aid poor people.

Feldstein asked Stockman how he would respond to the argument that Social Security recipients and near recipients have strong positive feelings for the program while the rest of the public does not care enough to express its opposition. *Stockman* said that the existence of constituencies with concentrated interests is not an agency problem but rather an inherent feature of democracies.

Schultze suggested two pieces of evidence against Niskanen's hypothesis of a severe agency problem. The first is that government spending is higher in many affluent countries whose parliamentary systems force their governments to respond more quickly than the U.S. government to shifts in public opinion. The second is the public support in the United States for increases in Social Security; Social Security provides an excellent test of Niskanen's hypothesis because taxes are increased along with benefits.

Niskanen responded that what is regarded as reality inside the Beltway is very different from what is regarded as reality outside the Beltway. Many politicians vote for increases in spending and give speeches to special interest groups in favor of spending, but the speeches they give "on the rubber chicken circuit" are not supportive of big government. Niskanen thought that the catastrophic health insurance episode of 1988 and 1989 provided an interesting lesson. This is the one major welfare program that had been reversed in his lifetime, and its dominating characteristic was that the population group that was supposed to benefit from the program was the same group that bore the taxes. This is not true of Social Security or Medicare or most other programs.

Feldstein said that a large part of the public does not agree with either of Niskanen's conceptions of responsible fiscal policy. Despite the efforts of many economists, many people believe that the budget deficit is not a big problem, so there is no urgent need either to raise taxes *or* to reduce spending.

Stockman said that the public had been deliberately miseducated for a long time because of a "reign of terror in the political system" in which "one side went into the bunkers and the other side postured and told lies." Slowly the country is coming out of this hole, and the political debate is reemerging in mature form. The public will start to be educated again, but it takes time to repair the damage that was done.

Paul Krugman summarized the Schultze/Stockman view of budget policy as the view that the United States has a basically sound political process that spent the 1980s trying to recover from two months of craziness in early 1981. Krugman disputed this view, arguing that what happened in Washington in early 1981 had not been just an accident in the political process or an operational failure of a few people inside the Beltway. Instead, Krugman believed that a mass movement had arisen in the United States that demanded impossible things from the government. This led to tax cuts and budget problems at the state and local level as well as at the federal level.

Krugman said that he had been doing some informal and painful research about public opinion by appearing on some radio talk shows. He had concluded that the public view of the country's fiscal problems is dominated by two false ideas. First, people believe that the United States has a crushing burden of taxes, by both historical and international standards. Second, they believe that most government spending goes to vast armies of unproductive bureaucrats. Mythical figures—like bureaucrats looking after their one Indian or welfare queens driving Cadillacs—loom very large in the public perception. Krugman hypothesized that this mass movement of impossible demands had arisen largely from the stagnation of American living standards in the 1970s and had nothing to do with the government per se.

William Poole commented that, over the past fifty years, U.S. government spending relative to GNP has been rising by an average of roughly 5 percentage points per decade. In Europe, this process has gone much further; Sweden may be at a level of spending and taxes that is past the top of the Laffer curve. This process cannot be continued indefinitely, and Poole thought that, even if government spending had not been reduced by much in the 1980s, the appropriate role of that spending had at least been addressed in a way that it had not been addressed before.

Stockman agreed that the rhetorical propositions about the expansion of government had become more negative and skeptical during the 1980s, which was an accomplishment. But he took issue again with the notion that the Reagan era had stopped an ongoing expansion of government that would otherwise have continued forever. In fact, he argued, the massive expansion of the welfare state had exhausted itself—or completed its task, depending on one's view—

in the late 1970s in nearly every Western country. The expansion had stopped in Britain under Prime Minister Thatcher and had stopped in the United States under President Carter. Three big projects that could have maintained the momentum of expansion in the United States—a guaranteed family income, national health insurance, and significant federal aid to education—were all killed by the Democrats. Social Democratic parties around the Western world had concluded in the late 1970s that their work was done. President Reagan had solidified this position in the United States, but the forces were already in motion in the body politic.

Stockman responded to Krugman's comments as well, saying that the public's mistaken notions about what is in the budget and how money can be saved had originated with or at least been reinforced by President Reagan. Reagan had believed in these ideas and had repeated them incessantly in speeches. As a specific example, Stockman recalled a discussion that he had had with Reagan about ways to reduce spending on Social Security. Stockman had proposed either a reduction in the cost-of-living adjustment or a targeted program to reduce certain types of benefits. But Reagan had said that he did not want to cut any benefits that people had earned; he just wanted to eliminate the waste in the program. The specific waste that he had mentioned was from people who had died but were still receiving benefit checks. So the administration had studied this issue and had made an administrative change that eliminated this waste—which amounted to $20 million in a $250 billion system. Because the public had been so miseducated, the political system was unable to restore revenue when it was needed.

Schultze agreed that there had been a gradual disenchantment with the welfare state around the world and a desire to stop its expansion. But the United States had responded by cutting taxes, and other countries had responded by cutting spending.

Feldstein noted another remarkable difference between the restraint of the welfare state in the United States and its restraint in other countries. Although the same forces had taken hold at the same time around the world, this had occurred at very different levels of spending in different countries.