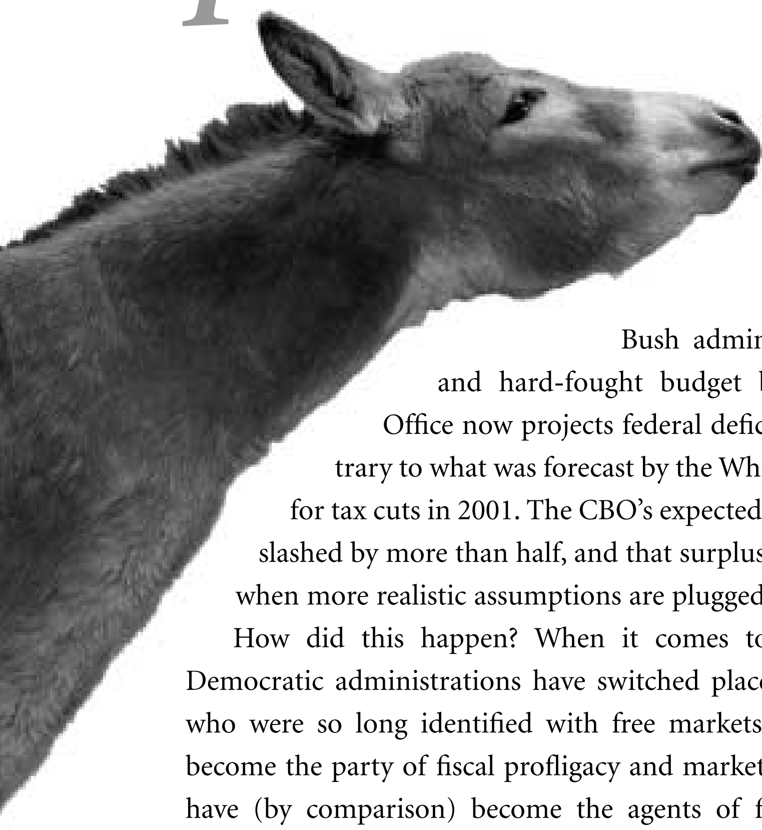
Trading places



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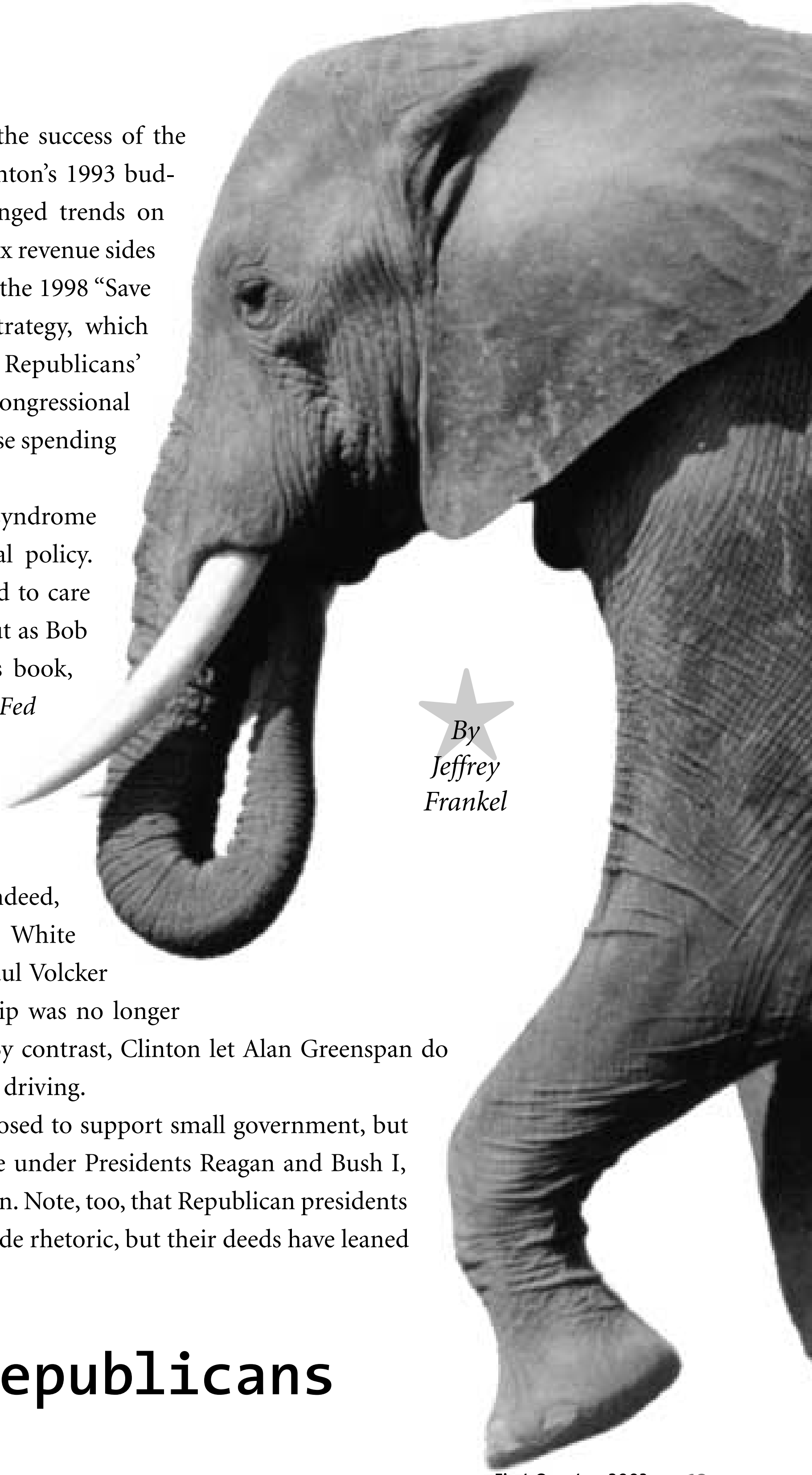
Almost overnight, the Bush administration threw away a long-sought and hard-fought budget balance. The Congressional Budget Office now projects federal deficits lasting well into the future – contrary to what was forecast by the White House when it successfully pressed for tax cuts in 2001. The CBO's expected cumulative ten-year surplus has been slashed by more than half, and that surplus morphs into a huge projected deficit when more realistic assumptions are plugged in.

How did this happen? When it comes to economic policy, Republican and Democratic administrations have switched places since the 1960s. The Republicans, who were so long identified with free markets and less-is-more government, have become the party of fiscal profligacy and market intervention. Democratic presidents have (by comparison) become the agents of fiscal responsibility and arms-length microeconomic policies.

Note, for starters, the aforementioned tendency for budget deficits to rise during Republican administrations. There is no mistaking the link between the Reagan and Bush tax cuts legislated in 1981 and 2001 respectively, and the dramatic shift in the long-term budget outlook. By contrast, declining deficits and then record surpluses were achieved during the Clinton years. While a variety of factors, some of which are only indirectly influenced by Executive policy, drive deficit arithmetic, two very delib-

How To Tell the Democrats



erate steps were key to the success of the 1990s: (1) President Clinton's 1993 budget package, which changed trends on both the spending and tax revenue sides of the equation, and (2) the 1998 "Save Social Security First" strategy, which parried Congressional Republicans' efforts to cut taxes and Congressional Democrats' efforts to raise spending as surpluses appeared.

The trading-places syndrome does not end with fiscal policy. Republicans are expected to care more about inflation. But as Bob Woodward noted in his book, *Maestro: Greenspan's Fed and the American Boom*, it was Presidents Reagan and Bush I who pressured the Fed to ease monetary policy. Indeed, such was the level of White House meddling that Paul Volcker decided the chairmanship was no longer worth having in 1987. By contrast, Clinton let Alan Greenspan do his job without backseat driving.

Republicans are supposed to support small government, but federal employment rose under Presidents Reagan and Bush I, and shrank under Clinton. Note, too, that Republican presidents have been big on free trade rhetoric, but their deeds have leaned

By Jeffrey Frankel

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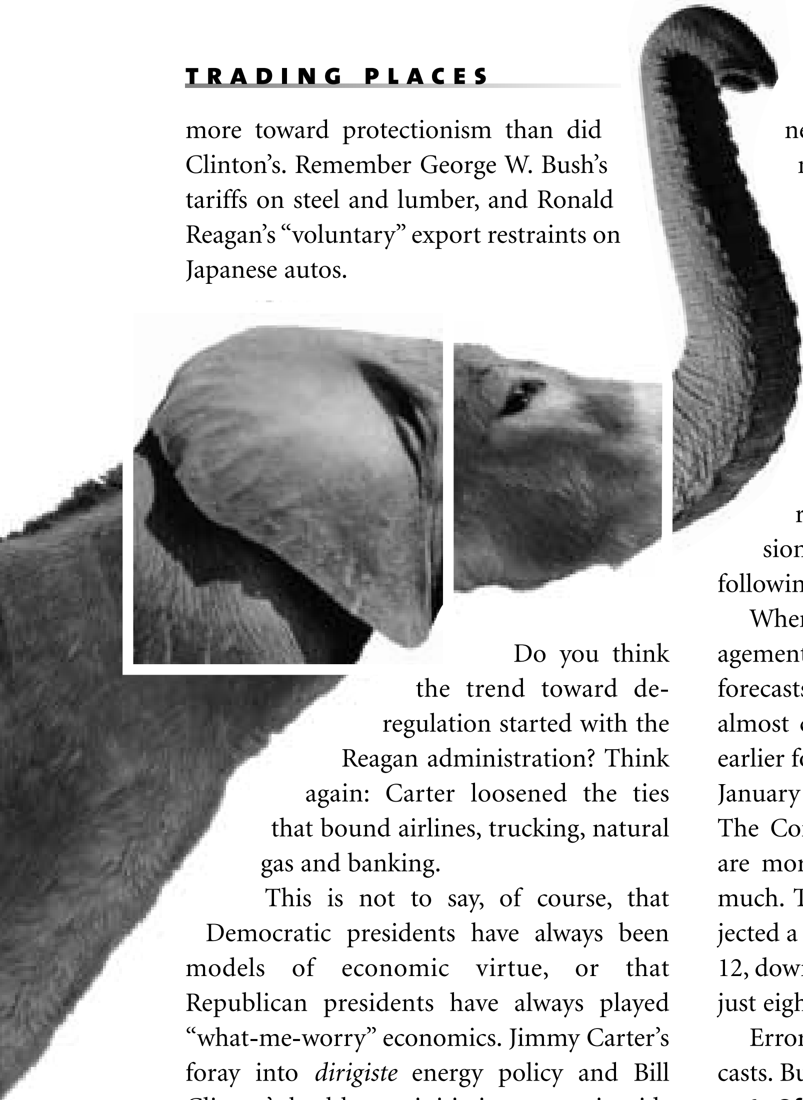
from the Republicans

more toward protectionism than did Clinton's. Remember George W. Bush's tariffs on steel and lumber, and Ronald Reagan's "voluntary" export restraints on Japanese autos.



Do you think the trend toward deregulation started with the Reagan administration? Think again: Carter loosened the ties that bound airlines, trucking, natural gas and banking.

This is not to say, of course, that Democratic presidents have always been models of economic virtue, or that Republican presidents have always played "what-me-worry" economics. Jimmy Carter's foray into *dirigiste* energy policy and Bill Clinton's health care initiative were misguided. Conversely, Ronald Reagan's firing of striking air traffic controllers changed the wage bargaining climate in ways that helped to break the back of inflation. George Bush I's 1990 decision to revoke his "no new taxes" campaign pledge was a brave step, which presaged Clinton's later efforts to eliminate the budget deficit. Nevertheless, it is striking how many examples go the other direction – and more striking still that public awareness of this political cross-dressing has not caught up with reality.

The White House's current inclination to opt for guns *and* butter only raises the stakes. If we are going to be spending more on security, we should be asking more of Americans – not passing out the goodies. The economies of Japan and Germany are each stuck in low-growth traps as the result of bad economic policy decisions. The United States is in danger of following them into the mire.

When the White House Office of Management and Budget releases its 2003 budget forecasts in February, the fiscal outlook is almost certain to be worse than revealed in earlier forecasts – just as its initial forecasts in January 2001 have already proven optimistic. The Congressional Budget Office's forecasts are more closely tied to reality, but not by much. The CBO's August 2002 forecast projected a $1 trillion surplus for the years 2003-12, down from the $2.2 trillion figure forecast just eight months earlier.

Errors are inevitable in long-term forecasts. But systematic biases are at work here.

1. Official projections assume that discretionary spending will increase only 2.7 percent a year – enough to keep even with inflation, but in no way enough to account for a growing population or growing demand for services linked to rising living standards. The nonpartisan Concord Coalition estimates that if spending were to stay constant as a share of GDP, it would increase by $1.1 trillion in the decade (or $1.3 trillion when rising interest on the federal debt is included) – enough to wipe out the CBO's projected surplus.

The notion that spending will remain proportional to GDP is hardly liberal pie-in-the-

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sky. Government outlays over the past four years have been rising at more than double that rate, and the pace shows no signs of abating. The national security menu includes new initiatives ranging from fighting terrorism, to fighting Iraq, to missile defense. Meanwhile, both parties favor a prescription drug benefit for Medicare. And a host of lesser initiatives are likely to add avoirdupois to the spending side.

Spending discipline was reestablished in the 1990s only by means of legislated caps, and an agreement not to touch the Social Security surplus. Those spending caps have now expired, and what little remained of the Social Security "lockbox" after the 2001 tax cut was blown to smithereens on September 11. Thus the political dynamic on fiscal policy has reverted to that of the 1980s. Perhaps worse, from the viewpoint of budget balance, is the return of one-party rule. In the 1980s and '90s Congressional gridlock inhibited major new spending increases and tax cuts. That source of inhibition is now gone.

2. Rosy Scenario, the muse of budget forecasting discovered by David Stockman, President Reagan's budget director, is alive and well and living in the Budget Office. Tax receipts depend on income. The official budget forecasts call for a rate of growth in real income well above 3 percent over the next 10 years. When I worked in the White House from 1996 to 1999, real growth was averaging above 4 percent. But we knew there was a chance that it would prove unsustainable – that the information technology boom would fizzle, that the New Economy would prove to be part-hype, that recession was still possible. Hence we conservatively assumed a long-run growth rate of less than 3 percent.

The last few years proved good times do have a way of ending, or at least slowing down. Yet White House forecasts are now underpinned by substantially higher productivity growth than we assumed in the late 1990s.

Did the previous administration also have its thumbs on the scale? Not while I was in the White House. But you don't have to take my word for it: the Clinton administration's mistake was to *underestimate* economic growth, tax revenues, and budget surpluses – not useful in furthering the goals of "big-spending Democrats."

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Future tax receipts also depend on "technical" assumptions. In the 1990s, tax revenues increased serendipitously, even after adjusting for unexpectedly rapid income growth. It seemed likely that the windfall was linked to the soaring stock market – to capital gains and stock-option compensation – and that the increase should therefore not be extrapolated into the future. And sure enough, during the past two years of sharp declines in the stock market, tax receipts were lower than the models predicted, even given the disappointingly slow growth of income.

Thus one might have expected the stock market doldrums to lead to downward revisions of revenue estimates. Instead, some Congressional Republicans are gilding the wilted lily, actually pushing CBO to adopt "dynamic scoring" that would institutionalize a degree of over-optimism in projections still worse than the current system.

3. The Republicans are proposing to make the 2001 tax cuts permanent, in addition to extending other tax cuts that are scheduled to expire. The Concord Coalition estimates that this will cost another $1 trillion in revenue in the 2003-12 budget window (and a lot more thereafter, of course). And in December, CBO confirmed the obvious: making the tax cuts permanent would wipe out the nominal $1 trillion surplus. Combine the revised revenue forecast with an increase in outlays to keep up with the size of the economy, and yesterday's 10-year, $1 trillion surplus becomes today's $1.5 trillion deficit. Or, projecting an 8.5 percent rate of increase in discretionary spending (the rate of the last four years), we get a deficit of $2.9 trillion.

4. The not-so-small matter of Social Security and Medicare still looms. The baby boom generation will begin to retire at the end of this decade. And while the two trust funds behind them are not broke, there won't be nearly enough money to cover the benefits on a pay-as-you-go basis. The Bush administration's proposals to partly privatize Social Security are beside the point, because they wouldn't affect existing liabilities.

Benefits will thus almost certainly have to be cut in coming decades; the only question is how much. This issue is not one that can be addressed in a 10-year budget window. However, if we are not going to concern ourselves in the budget context with these future liabilities, we should at least not count earmarked Social Security tax revenue in 10-year budget projections. If we opt for the more responsible approach, the 10-year projected deficit reaches $4 trillion – or even $5.4 trillion if we (quite reasonably) extrapolate from spending increases in the past four years.

5. All the projections assume that Washington will allow the Alternative Minimum Tax to bite into the take-home pay of the middle class. Economist Bill Gale of the Brookings Institution points out that the AMT was enacted to quell outrage over the fact that 155 rich people paid no taxes at all in 1969 – mostly because they collected oodles of interest from tax-exempt bonds. But because the AMT is not indexed to inflation, it will apply to 36 *million* by 2010. Nobody thinks this should (or will) be allowed to happen.

Economists Alan Auerbach, Bill Gale and Peter Orszag estimate that adjusting the AMT so that it bites the same number of taxpayers in 2010 as it did in 2002 would reduce revenues by another $700 billion over 10 years. When this $700 billion is added to the costs of making the tax cuts permanent and letting spending grow with the economy, the bottom line is a $5.4 trillion deficit.

WHAT TO DO ABOUT THE TAX CUT

The 2001 tax cut, which reduced 10-year revenues by an estimated $1.3 trillion, obviously played a large role in changing the long-term fiscal outlook. Some sort of tax relief was not necessarily a bad thing, especially in a recession year like 2001. But the specifics were dubious. A well-designed tax cut should:

- be timed to be countercyclical, increasing private purchasing power when the economy ebbs and phasing out when growth is restored.
- be responsible in the sense of not eroding the tax base in the long term.
- increase incentives to work and invest.
- be fair in the sense of not increasing inequality in after-tax incomes, especially in an era of rising inequality.
- simplify taxpayer compliance and planning.

While there were a few bright spots in the tax package – for example, the $300 rebate was well timed in terms of the business cycle – for the most part it failed all five tests. You think lower rates increased incentives to work? According to Treasury data, fully 64 percent of those with positive tax liability get no cut in taxes on an extra dollar of income.

The estate tax cut was particularly egregious in this regard. Almost any tax cut would have more attractive incentive and equity effects than the elimination of the estate levy. Furthermore, the plan to eliminate the tax in the year 2010 simultaneously manages to violate the criteria of countercyclical timing (we needed stimulus in 2001, not 2010) and simplification of planning (hardly anyone believes that the 10-year plan that was enacted into law will stand as it is, making planning very difficult).

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In 2010 the federal exemption from estate taxes, which will then be $3.5 million, is due to be raised to infinity – for just one year! Then it will bounce back to only $1 million in 2011 – the assumption built into current official revenue projections. This anomaly will, of course, vanish if the 2001 tax cuts are made permanent, as the White House wants. But the implications for the post-2010 federal finances would be dismal, indeed.

There is little political support for recapturing the $1.3 trillion revenue, but it might be possible to shuffle both the beneficiaries and the timing of the benefits. I would cap the estate tax exemption at a modest level. This would save revenue that could be used to fix the alternative minimum tax, to give low-income workers the same break on their payroll taxes the rest of us got in 2001 on income taxes, and to raise the standard deduction on the income tax. Other possible uses for the revenue – particularly if the economy weakens again – include extending unemployment benefits or returning some of the money to the hard-pressed states to spend on health insurance and education. Any cuts should take effect now, not years in the future, if the point is to strengthen the recovery today.

WHAT EXPLAINS ROLE REVERSAL?

It's a grand puzzle. After all, Congressional

Democrats are no more committed to free trade and small government than their Republican counterparts. A plausible explanation stems precisely from the fact that Democrats remain saddled with the big-government image. Hence they believe they can't elect a president unless they bend over backwards to prove their commitment to mainstream policies. The public seems willing, however, to accept Republican presidents who believe that it is enough to talk the talk without walking the walk.

If economic reality were so simple that "small government" was always the right answer (or, for that matter, if "big government" were), it would be hard for any president to live with the contradiction. But there is almost always some intellectual and ideological wiggle room on the issues. Various forms of market failure call for appropriately targeted government intervention by Republicans or Democrats, while "doing nothing" is not a meaningful option in monetary and fiscal policy. Thus consistent policy does not always imply laissez faire.

Examples of regulation that can fit the worldview of policymakers across a broad swath of ideology range from antitrust policy aimed at price-fixing, to pollution regulation that forces producers and consumers to bear the costs of their own emissions. Neither party has consistently distinguished itself in the design of regulation. But by the 1990s, antitrust and environmental regulation espoused by both parties had become more consistent with good economics. For example, the system of tradable permits in power plant emissions of sulfur dioxide minimizes the cost of achieving mandated cleanups.

But this good-government convergence has hardly ended the push and pull of interest group politics. An example of botched regulation that received a lot of attention recently is corporate governance. Then-SEC Chair Arthur Levitt warned about conflicts of interest within accounting firms that sold management consultant services to the same clients. Democrats, as much as Republicans, prevented him from doing anything about it. But Levitt was appointed by Clinton. President Bush, by contrast, appointed Harvey Pitt as Levitt's successor – apparently in order to reduce the level of SEC oversight.

When it comes to monetary and fiscal policy, even a libertarian has to admit that a belief in the virtue of minimal government is not an all-purpose compass. In the face of large budget deficits, does the small-government principle tell you to cut taxes to improve work and saving incentives – or to raise taxes, so government borrowing doesn't crowd the private sector out of capital markets?

Proponents of tax cuts passionately assert the former. If the ultimate goal is cutting spending, they say, a pragmatic means toward that end is to cut taxes first – thereby creating a budget deficit that will pressure Congress to cut spending. (Leave aside that a majority of Republican congressmen who make this argument cannot, in fact, come up with a list

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of things they are willing to cut.)

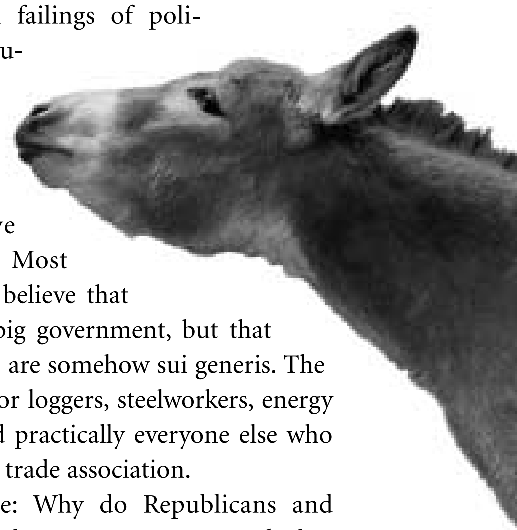
But there is a logical flaw in the hypothesis that deficits put more downward pressure on spending than does a legal rule that taxes must be raised to pay for incremental spending. The theory implies that congressmen worry more about getting grief from their constituents over future increases in the national debt than about the grief they get from their constituents over taxes they'll pay on April 15. Perhaps deficits do put some downward pressure on spending. But the threat of higher taxes today (as opposed to, say, the threat of high taxes in 20 years) is surely more potent. If you want to create a political mechanism for restraining growth in spending, pass a law that any spending increases must be matched with current revenues. That is roughly what we had in the 1990s, and it largely worked. Cutting taxes manifestly does not.

The other argument is somewhat technical. According to the conventional wisdom, deficits create a shortfall of national saving – which drives up real interest rates and raises the cost of capital. The counterargument is that private saving will increase in anticipation of the need to pay taxes to service the national debt down the road, so there is no net impact on the credit markets. Much is made of this latter hypothesis when some particular econometric study reveals no evidence that budget deficits do indeed raise the cost of capital. Still, the claim that borrowing trillions of dollars from savers has no effect on interest rates paid by private borrowers seems implausible on its face. The smoking gun is hard to find because interest rates are determined by many influences. But it is even harder to find evidence that budget deficits lead to increased private saving. There is little question that budget deficits eat up aggregate national saving, and therefore "crowd out" private investment, whether via the interest rate or otherwise.

A LITTLE SUBTLETY, PLEASE

It is easy to fall into the trap of thinking that governing is a matter of sticking to the playbook. But a president who views the world in such simplistic terms will not be prepared for the work of sifting through ambiguous information, making political tradeoffs, and confronting interest groups. That, alas, is what good economic policy demands.

Excessive intervention is less the product of the moral failings of politicians and bureaucrats, and more the consequence of representative government. Most farmers truly believe that they oppose big government, but that farm supports are somehow sui generis. The same is true for loggers, steelworkers, energy executives and practically everyone else who pays dues to a trade association.



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Once more: Why do Republicans and Democrats exchange garments? Mostly because traditional fashions in governing have little to do with contemporary realities in policy or politics.

Editor's Note: Worried that Jeff Frankel's version of recent economic history is partisan? Check out these books, which contain the recollections of key Republicans and Democrats, as well as those of astute neutral observers:

American Economic Policy in the 1980s, *edited by Martin Feldstein (University of Chicago Press, 1994).*

American Economic Policy in the 1990s, *edited by Jeffrey Frankel and Peter Orszag (MIT Press, 2002).*