4500a words (Dec. 19, 2002)

# *Republican and Democratic Presidents Have Switched Economic Policies*

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*Forthcoming, Milken Institute Review*

*[This article expands on ideas in an op-ed that appeared in the Financial Times, September 13, 2002.*
*The author would like to thank for useful comments Jack Frankel, Bill Gale, Jeff Liebman, Arnold Kling and Peter Orszag.]*

Almost overnight, the Bush Administration has thrown away long-sought and hard-fought budget balance. Official projections from the Congressional Budget Office now show renewed federal budget deficits lasting well into the future, contrary to what was forecast by the White House forecasts when passing its tax cuts. The projected cumulated 10-year surplus has been slashed by more than half, relative to CBO's last forecast in March. The truth is in fact worse than that, for many reasons. How did this happen? How did the Republican Party, long associated with fiscal conservatism, come to preside over so large a deviation from good economic policy?

## TRADING PLACES

The answer lies in a surprising fact, though it has long been in plain sight. When it comes to White House economic policy, the Republican and Democratic parties have switched places since the 1960s. By now the pattern is sufficiently well established that the generalization can no longer be denied: The Republicans have become the party of fiscal irresponsibility, trade restriction, big government, and failing-grade microeconomics. Surprisingly, Democratic presidents have – relatively speaking -- become the agents of fiscal responsibility, free trade, competitive markets, and good textbook microeconomics. This characterization sounds wrong on the face of it. Certainly it is not to be found in the two parties' rhetoric. But just compare the actual records of Presidents Carter and Clinton versus Reagan, Bush I, and Bush II. Such a comparison is facilitated by reading what those who participated in the last two decades of White House economic policy-making have to say about the specific decisions made.

A simple look at the federal budget statistics shows an uncanny tendency for the deficit to rise precisely during Republican presidencies. 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 that each engendered. In between the two, declining deficits and then record surpluses were achieved during the Clinton Administration. Although many factors determine the overall budget, two deliberate steps were key to this achievement: first, Clinton's 1993 budget package, which established new trends for spending and tax revenues such that the two paths converged later in the decade; and, second, his 1998 "Save Social Security first" strategy, which successfully blocked Congressional desires either to cut taxes (Republicans) or raise spending

(Democrats) and thus preserved the new surpluses. The history emerges in a new book containing recollections by such Clinton Administration figures as Rubin, Summers, Tyson, Barshefsky, Sperling, and Reich, together with Republican counterparts and neutral observers.*

The list of examples of economic policies where Republican presidents have traded places with Democrats over the last quarter century extends well beyond the budget. Republicans are supposed to place more emphasis on fighting inflation. But, in practice, Presidents Reagan and the first Bush pressured the Fed to ease up on monetary policy – sufficiently so that Paul Volcker decided the chairmanship was no longer worth having in 1987, according to Bob Woodward. In contrast, Clinton deliberately and unprecedentedly 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, and shrank under Clinton. Republican presidents have been big on free trade rhetoric. But their actions have in fact been protectionist, judged not just by some politics-free ideal, but as compared to the record of Clinton. Highlights include George W. Bush's tariffs on steel and lumber and Ronald Reagan's voluntary export restraints on autos. And the trend toward deregulation that most imagine began in the Reagan Administration? It actually began in the Carter Administration – in airlines, trucking, natural gas, and banking. Reagan at best continued the trend. These characterizations are shared by economists from across the political spectrum, as is clear in both the 1990s book, and in the earlier 1980s book on which it was modeled.***

This is not to say, of course, that Democratic presidents have done everything right, nor Republican presidents everything wrong. Jimmy Carter's initial energy policy and Bill Clinton's initial health care policy were misguided and ill-fated. Ronald Reagan's firing of the air traffic controllers, who were striking in violation of their contracts and the law, was a much admired stand on principle and the demonstration effect may have helped a bit to break the back of inflation. George H. W. Bush's 1990 decision to revoke his "no new taxes" campaign pledge was a brave step, which ranks of equal importance with Clinton's two measures, in establishing the 1990s path toward eventual budget balance. Nevertheless, it is striking how many examples go the other direction, and more striking still how seldom expressed is that assessment.

## FISCAL PROFLIGACY

The country has important economic decisions to make, and they should not be obscured by our current national security issues. Indeed, if we are going to be spending more on national security and seeking to reduce dependence on imported oil as well, we should be asking more of Americans, not declaring a party. We are now in danger of proceeding even further down a long-term path of fiscal irresponsibility. The economies of Japan and Germany are each mired in their respective long-term low-growth swamps as the result of bad economic policy decisions that they made ten years ago. The United States is in danger of making analogous mistakes today.

When the White House Office of Management and Budget releases its 2003 budget forecasts in February, they will almost certainly show that the fiscal outlook is worse than it revealed in its earlier forecasts, just as it has been forced to do in its previous revisions since the original overoptimistic forecasts in January 2001. The forecasts released by the Congressional Budget Office are probably a bit more accurate, but not much. CBO's last official biannual forecast, in August 2002, projected a $1.0 trillion surplus, for the federal budget cumulated over 2003-2012. That was a sharp downgrading of the supposed 10-year cumulative surplus that had previously been forecast.[1] Large errors are inevitable in such forecasting. But there are systematic biases at work here. Notwithstanding that the official forecasts of the budget surplus have been drastically reduced since the 2001 tax cuts were enacted, they are still grossly over-optimistic. There are five reasons for this. They mostly derive from the "current legislation" rules under which CBO must operate, and are not the fault of CBO staff.

1. First, the central numbers in the official projections assume that ***discretionary spending*** by the government will increase at only 2.7 per cent a year, in dollar terms, just enough to keep even with inflation, rather than rising along with population, let alone

[1] CBO had forecast a $2.2 trillion 10-year surplus in January 2002.

with income. The non-partisan Concord Coalition estimates that if spending were to stay constant as a share of GDP, it would add $1.1 trillion in costs cumulated over the next ten years (2002-2012), enough *in itself* to wipe out the officially projected cumulated $1 trillion surplus.[2]

The notion that spending will increase with the size of the economy is not a liberal assumption; it is in fact a conservative assumption. Spending has over the last four years been rising faster than that, at 8.5 % a year. This is likely to continue, for several reasons:

a. Increased national security spending. This includes the war on terrorism and a possible war in Iraq.[3] Furthermore, even before September 11 the Pentagon was planning to increase spending on other unrelated defense projects, such as strategic missile defense, but it had not been put into the budget.
b. Both parties favor a prescription drug benefit.
c. Increased spending on agriculture and a host of other items.
d. Spending discipline was re-established in the 1990s only by means of legislated caps, and an agreement not to touch the Social Security surplus (remember the lockbox?). The spending caps have now expired, and what little remained of the lockbox after the 2001 tax cut was blown to smithereens on September 11. Thus the political fiscal dynamic has reverted to that of the 1980s.

[2] *Budget Update: The Return of Deficits*, September 2002, The Concord Coalition, Arlington, VA.
[3] Bill Nordhaus estimates that the decadal budgetary costs of an invasion of Iraq might be from $156 billion to $755 billion, in 2002 dollars, depending on length of the war and extent of reconstruction. He also

e. Worse, from the viewpoint of budget balance, is the return of one-party rule. It has been argued that in the 1980s and 90s Congressional gridlock inhibited major new spending increases or tax cuts. That inhibition is now gone.

2. ***Overoptimism on the tax revenue*** side is as bad as on the spending side. David Stockman, President Reagan's budget director, gave the name "Rosy Scenario" to the muse of the 1981 budget forecasts. Rosy has now returned to Washington. The Bush forecasts were overly optimistic in January 2001, and they still are.

(a) Future tax receipts depend on future income. The official budget forecasts call for a rate of growth in real income well above 3 percent over the next ten years. When I worked in the White House during 1996-1999, even though real growth was averaging around 4 ½ %, we knew that there was some chance that the contemporaneous productivity growth rate would prove unsustainable, that the IT boom would halt, that the New Economy would prove partly illusory, or that there would be recession within the next five years. For these reasons, we assumed a modest long-run growth rate substantially less than 3 %. Today we know that a component of the late-1990s IT and productivity boom was indeed temporary or illusory -- not all, but some. And yet official forecasts in the White House depend on substantially higher productivity growth looking forward than we assumed in the late 1990s! Nobody

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documents the historical tendency to underestimate the cost of war. "The Economic Consequences of a War with Iraq," NBER Working Paper No. 9361, December 2002.

knows what the growth rate will be. But what reason could the current Administration have for making more optimistic forecasts than the previous administration, other than to bias the results in favor of more tax cuts?

It would be natural to wonder whether the previous administration might also have had ulterior motives for its forecasting mistakes. Since the Clinton Administration's mistake was to *under*estimate economic growth, tax revenues, and budget surpluses, the ulterior motive could not possibly have been to bias the process in favor of increased spending, the usual charge against "big-spending Democrats." Anyone wishing to argue that the nation could afford a lot more spending would have wanted to err in the direction of optimistic forecasts, not pessimistic. This just makes the point, again, that the Clinton Administration did not fit in the big-spending tradition.[4]

(b) Future tax receipts also depend on so-called technical assumptions. In the 1990s, tax receipts increased unexpectedly, even relative to rapidly growing income. It seemed likely that the extra revenue was related to the soaring stock market -- for example, capital gains and taxation of stock options compensation -- and that the increase should therefore not be extrapolated far into the future. Sure enough, during the last two years of sharp declines in the stock market, tax receipts are low even given a disappointment on income. Again, the turnaround in the stock market since 2000 should cause us to revise our revenue estimates downward, not upward. Instead, some Congressional Republicans are pushing CBO to adopt so-called "dynamic scoring," which would in practice produce a degree of over-optimism in tax projections still worse than the current system.

3. The Republicans are proposing to ***make permanent the tax cuts*** that were legislated in 2001 (e.g., the phasing out of the estate tax by 2010), in addition to the regular extension of other tax cuts that are legally scheduled to expire. The Concord Coalition estimates that this will cost another $1.0 trillion in the 2003-2012 budget window (and a lot more thereafter, of course). Together with their spending assumptions, that would bring the projected ten year deficit to $1.8 trillion. On December 4, in response to an inquiry from Sen. George Voinovich, CBO confirmed these findings: making the tax cuts permanent would wipe out the supposed $1 trillion surplus. When combined with a trend increase in outlays to keep up with the size of the economy, it leaves a 10-year deficit of $1.5 trillion, in place of the $ 1 trillion surplus that CBO forecast in August.[5]

4. These calculations forget about ***Social security and Medicare.*** The baby-boom generation will begin to retire at the end of the decade. While the trust funds are not broke, neither is there enough money saved up to meet the benefits that have been promised. (Bush Administration proposals to privatize Social Security are beside the point, because they don't address the existing gap in financing benefits

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[4] As it happens, President Clinton did not pressure his forecasters in either direction.

that have already been promised.) As a result, benefits will 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 ten-year budget window. But if we are not going to concern ourselves in the budget context with these future liabilities, we should at least not count within the ten-year budget window the ear-marked Social Security tax revenue. Leaving the Social Security surplus intact is what politicians of both parties agreed to do two years ago: leave the current social security surplus untouched. The December 4 letter from CBO noted that, taking out the $2.5 trillion in tax revenues that are supposed to go to Social Security, and combining with the other factors Senator Voinovich asked about, the $1 trillion surplus becomes *$4 trillion deficit*. [6]

5. The projections assume unrealistically that the **Alternative Minimum Tax** will be allowed to affect a vastly enlarged fraction of households. In reality, the AMT will have to be fixed, and this will cost money. It was meant to apply only to the rich. Bill Gale points out that the AMT was inspired by concerns that 155 rich people in 1969 had paid no taxes. But because the rule is not indexed to inflation, it hit 1 million in 1999 and 2 million this year, and will apply to 36 million by 2010, including virtually all upper-middle class families with 2 or more children. That does not include the even larger number that have to do a lot of extra paperwork even if they end up owing no extra tax. Nobody thinks that

[5] Or, when combined with a rate of increase in discretionary spending equal to that of the last four years (8.5%), it leaves us with a cumulative deficit of $ 2.9 trillion.
[6] If spending increases at the higher rate, then the cumulative deficit becomes a staggering $5.4 trillion. In the year 2012, the on-budget deficit runs $866 billion, compared to the record $341 billion deficit of 1991.

this will be allowed to happen. Auerbach, Gale and Orszag estimate that it will cost another $0.7 trillion over the period to fix the AMT. ("Fixing the AMT" here does not mean abolishing it, but adjusting it so that it affects the same proportion of the population in 2010 as it does today.) When this 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.[7]

In short, the long-term fiscal outlook is not good. While we castigate Argentina and Brazil for their supposed budgetary profligacy, the fact is that these afflicted countries have taken difficult steps in the direction of discipline. Our current fiscal trend makes them look paragons of fiscal virtue by contrast.

## WHAT TO DO ABOUT THE TAX CUT

The $1.3 trillion tax cut passed in 2001 obviously played a large role in changing the long-run fiscal outlook**.** Passing some sort of tax cut was not necessarily a bad thing, especially in a recession year. But**,** the specifics were dubious. A well-designed tax cut should be**:**

- **Timed**, regarding business cycle[8]
- **Responsible**, regarding the long-run fiscal outlook

[7] A. Auerbach, W. Gale and P.Orszag, "The Budget Outlook and Options for Fiscal Policy," Brookings Institution, April 2002. The $5.4 billion figure is updated to CBO's August 2002 baseline, but still without the most pessimistic scenarios on spending and revenue growth.

- **Efficient**, regarding economic incentives[9]
- **Equitable**, regarding low-income workers, and
- **Simplifying**, regarding taxpayer planning

Amazingly, the tax cuts pushed through by President Bush in 2001 pretty much failed all five tests ! I particularly have in mind the estate tax. Almost any tax cut would have better incentive effects and equity implications than wiping out the estate tax. Furthermore, the plan to eliminate it in the year 2010 manages simultaneously to violate the criteria of cyclical timing (we needed stimulus in 2001, not 2010) and simplification of planning (nobody really believes that the 10-year plan that was enacted into law will stand as it is, making planning very difficult).

In 2010 the exemption on estate taxes, which will then be $3.5 million, is due to be raised to infinity – for one year. It is as absurd to eliminate the tax entirely in 2010 as it is to allow it to bounce back to $1 million in 2011 and thereafter – the assumption built into current official revenue projections. If that situation were allowed to persist, then the heirs to an elderly person with a large estate would stand to gain or lose millions of

[8] The $300 tax rebates were cyclically well-timed. The rest of the package was not.

[9] Reductions in marginal tax rates can increase efficiency by increasing the incentive to work. But despite the cuts in future marginal income tax rates that were legislated in 2001, 76 percent of filing units (including non-filers), 72 percent of filers and 64 percent of those with positive tax liability get no cut in marginal tax rates, because they either don't pay taxes, are in the unaffected part of the old 15 percent bracket, or get hit with the AMT. (According to Treasury data. D. Kiefer, et al, "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assemssment of Effects on Taxpayers," *National Tax Journal*, March 2002; and W.Gale and S.Potter, "An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," *National Tax Journal*, March 2002.)

dollars depending arbitrarily on whether or not their benefactor dies between January 1 and December 31, 2010. [10]

My proposal would be to keep the magnitude of the $1.3 trillion in tax cuts that were legislated, but reallocate their distribution over time and across people. Why do I suggest retaining the magnitude of the tax cuts? Politics. Although it is possible that the American people would not have approved the measure if they realized the corresponding cuts in future Social Security and Medicare benefits that will likely be necessary, the political support for rescinding the tax cuts is currently very small. But we should at least refrain from increasing the magnitude of the revenue loss by making all the cuts permanent. And, most importantly, we should reallocate the distribution along more sensible lines.

More specifically, I would propose that the estate exemption be raised no higher than $3 million, and that it then be left at that level (in real terms) subsequently. This would save revenue that could be used in ways more in keeping with the desirable characteristics listed above:

1) fix the AMT

2) give low-income workers the same break (on their payroll taxes) that the rest of us got in 2001 (on our income taxes).

3) raise the standard deduction on the income tax.

[10] This anomaly will disappear if the elimination of the estate tax is made permanent, as the Republicans want. But then the implications for the post-2010 federal finances are very bad indeed. In the subsequent decades, just as Social Security and Medicare benefits are being cut severely, because there is no money to pay for them, $100 million estates will pass in their entirety to heirs who did nothing to earn the money. How many years would that situation last before the political pendulum once again swings back sharply in the direction of redistribution?

4) Other possible uses for the revenue – particularly if the economy weakens again -- include extending unemployment benefits or returning some to the hard-pressed states to spend in such areas as health and education. Measures such as items (2)-(4) should take effect today, not years in the future, if the point is to strengthen the recovery today.

## WHAT EXPLAINS THE ROLE REVERSAL?

If Republican and Democratic presidencies have indeed reversed roles, what is the explanation? I am not sure. After all, the Democrats in Congress, overall, are still less supportive of free trade and small government than the Republicans. Perhaps an explanation stems precisely from the fact that Democrats remain saddled with the image of big government. For that reason wary voters would never elect a Democrat president in the first place, unless he had specifically exhibited the will and ability to grapple effectively with the problems of government's role in the economy. The public seems willing, however, to accept Republican presidents who believe that it is enough to adopt the rhetoric of small government, even while their actions have the opposite effect. [Perhaps it has something to do with the persuasive powers of actors and cheerleaders.]

If economic reality were so simple that "small government" was always the right answer (or, for that matter, if "big government" were), then it would be hard for a president to get away with frequently doing the wrong thing. But, needless to say, reality is complicated. Even the most basic of economics textbooks emphasizes the existence of market failures in microeconomics and big policy questions in macroeconomics. Market failures call for appropriately targeted government interventions, while "do nothing" is not even a meaningfully defined option when it comes to monetary and fiscal policy. Thus good economics does not always simply mean "laissez faire;" nor does it mean "do whatever is good for business." These pitfalls at one end of the political spectrum are as serious as the familiar pitfall at the opposite end of the political spectrum -- "if there is a problem, government must be the solution."

Examples of the need for intelligent regulation are anti-trust policy to keep markets competitive, and environmental regulation to expose producers and consumers to the costs of their own pollution (to "internalize externalities"). Neither party has consistently distinguished itself in the design of its regulation. But by the 1990s, both antitrust and environmental regulation had become more consistent with good economics. For example, the system of tradable permits in regulation of power plant emissions of SO2 helps minimize cost per environmental benefit, or to maximize environmental benefit per dollar of cost. In its eagerness to help business, the Bush Administration upon taking office sought to throw out regulation, whether intelligent or not. (It made an exception for the kind of regulation that restrains competition and benefits a particular narrow business sector: agricultural subsidies, steel tariffs and subsidies to logging or oil drilling on government lands.)

An example of botched regulation that has received a lot of attention recently is corporate governance. Financial markets require a certain level of regulation to function well. Consider the SEC. SEC Chair Arthur Levitt warned us about compromised accounting firms and other dangers with which we are now only too familiar. It was Democratic senators as much as Republicans who prevented him from doing anything about the problems. But Levitt was appointed by Clinton. Bush, by contrast, appointed Harvey Pitt as Levitt's successor in order to reduce the level of SEC oversight.

When it comes to monetary and fiscal policy, even a libertarian has to admit that an adherence to small government principles is not in itself enough guidance to answer most questions. In the face of large budget deficits, does the small government principle tell you (1) to cut taxes, to improve work and saving incentives? Or (2) to raise taxes, so government borrowing does not crowd out the private sector in the capital markets?

Proponents of tax cuts assert passionately the first answer, but it is not always right. Two arguments, especially, are commonly heard. One argument comes from political economy, the other from econometrics. Both are flawed.

The first argument is that, if the ultimate goal is cutting spending, a political strategy is to cut taxes first, creating a budget deficit that will then put pressure on congress to cut spending. [Leave aside that a majority of Republican Congressmen who make this argument cannot in fact come up with a list of things they are willing to cut. ] But there is a logical flaw in the theory that deficits puts more downward pressure on spending than does a rule that taxes must be raised to pay for any incremental spending. The theory in essence says that congressmen worry more about getting grief from their constituents about the possible need for subsequent generations to pay the national debt than the grief they would get from their constituents over taxes today. Perhaps the existence of high deficits does put some downward pressure on spending. But the existence of high taxes puts even more pressure. If you want to create a political mechanism for restraining growth in spending, pass a law that any spending increases must be paid for at the same time. That is roughly what we had in the 1990s, and it worked. Cutting taxes manifestly does not.

The other argument is econometric, and therefore slightly technical. The concern that a feared long-term path of fiscal deficits will crowd out the private sector today, particularly business investment, is usually phrased in terms of the real interest rate. Deficits create a shortfall of national saving, which drive up real interest rates, which raise the cost of capital. The counterargument is that private saving will rise in response to a budget deficit, so there is no net impact on the credit markets. Here comes the technical part. One can find no shortage of econometricians who will testify "that there is little statistically significant evidence that budget deficits raise real interest rates." Some consider this a devastating argument against the crowding out hypothesis. The claim that if the government dumps a few trillion dollars of Treasury bonds into the financial markets it has no effect on bond prices or interest rates sounds implausible on the face of it. The problem is that interest rates are determined by many influences, and it is hard to sort out the budget effects from the rest. A fairly large number of studies do in fact find an effect.[11] But in any case, arguments about "little statistical evidence of an effect of deficits on the interest rate" are outweighed by the even greater statistical failure to find evidence of an effect on private saving. There is little question that budget deficits eat up national saving, and therefore that crowding out of the private sector occurs one way or another. If someone wants to argue that the channel of transmission is something other than the interest rate (it could be the stock market, for example, or even the exchange rate), that does little harm to the argument.

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[11] A comprehensive and up-to-date review is W.Gale and P.Orszag, "The Economic Effects of Long-Term Fiscal Discipline" Urban-Brookings Tax Policy Center Discussion Paper, December 17, 2002.

# A LITTLE SUBTLETY, PLEASE

It is easy to fall into the trap of thinking that governing is easy. Governing is not easy; it is very difficult. If a presidential candidate believes that everything is a simple question of good versus evil, then he is not prepared for the painstaking work of acquiring detailed information, making logical analysis of tradeoffs, and confronting difficult political interest groups. But that is what intelligent economic policy decisions in Washington require.

If a president takes office thinking that good policymaking is a simple matter of declaring his desire to oppose evil-doers, favor small government and eliminate "waste, fraud and abuse," he is ill-prepared for the complexities of the job. Excessive size and interventionism of big government come about, not primarily because of moral failings of Washington politicians and bureaucrats, but rather because we, the citizens, each want something from the government. Most farmers truly believe that they oppose big government, but that "farm supports are different." The same is true of loggers, steelworkers, energy executives, and every other interest group. Resisting the appeals of such specific interests well enough to safeguard the welfare of the whole requires more than that the president give small-government speeches. It even requires more than that he sincerely believe that he favors small efficient government.

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

** Bob Woodward, Maestro: Greenspan's Fed and American Boom, New York, Simon and Schuster, 2000.

*** American Economic Policy in the 1980s, edited by Martin Feldstein, University of Chicago Press, Chicago IL, 1994. (E.g., consider a quote from Bill Niskanen, a Member of Ronald Reagan's Council of Economic Advisers "…the administration imposed more new restraints on trade than any administration since Herbert Hoover." p. 628.)

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