

BUSH's BUDGET PROBLEM

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It was George W. Bush's misfortune to become President just about the time the stock market bubble burst, the economy weakened, and federal revenues plummeted. It will be his successor's misfortune to enter office with an inadequate revenue base and an urgent need to push a tax increase through Congress. But even if the next president reverses course on budget policy, the after effects of Bush's government-by-deficit strategy will linger for many years.

Assuming he wins a second term, Bush will be the last president before the front edge of the baby boom generation reaches retirement age. His successor will have to deal with the economic and budgetary implications of an aging U. S. population in ways that Bush has not. The future financing of social security and medicare are not the only problems the current President has slighted; he also has not faced up to the escalating costs of national defense and homeland security. During the first decade of the new century, the security costs added by Bush are likely to exceed the \$1.3 trillion his 2001 tax cut subtracted from federal revenues. Less than two years after this tax cut, during the period the United States was at war in Iraq, Bush pressured Congress to enact another trillion-dollar tax cut that was estimated to reduce federal revenues by \$330 billion, but whose full cost may be more than double.¹ When the books are closed on his presidency, a country that was moving at the beginning of the century to liquidate the \$3.7 trillion in federal debt held by the public will instead add \$1-to-\$3 trillion to the nation's debt burden. Which end of the range materializes will depend more on the length of Bush's stay in office than on the performance of the economy.

It is easy to tar Bush as fiscally irresponsible, as Democratic leaders and a few rank-and-file Republicans have. In the same week that warfare broke out in Iraq, key presidential aides were pressuring ambivalent Republicans in Congress to vote for a budget resolution that assured passage of his second tranche of mega tax cuts in 2003. Bush is the first president in American

history to combine a call to arms and significant tax reduction in the same political package. By some bad—not worst—case scenarios, Bush’s recipe will produce deficits in the vicinity of \$500 billion a year, almost double the previous record set by his father.

How did this president lose his way on fiscal prudence? Why didn’t he use 9/11 to rally support for taxes to finance homeland and national security? Arguably, had he done so, Bush might have been in a stronger position to ward off spending demands from Congress, including many from fellow Republicans. It may be that Bush miscalculated, that he did not know that the budget would spin out of control and that faced with a rush of bad news—a weak economy, spiraling defense costs, and plummeting revenues—he let things drift in the expectation that conditions would improve if he stayed the course. When they didn’t, he was left with a record budget deficit that could not be trimmed through politically acceptable options. In characterizing George W. Bush’s thinking, I mean to spell out the logic of the positions he takes, not to purport to psychoanalyze him.

Yet miscalculation does not fit this calculating president who, in contrast to his father, knows how to use the power of the office. This is a president who has not fought for a lot of things he professes to want—Medicare prescription drug coverage, abortion restrictions, and social security reform to name some of his most prominent aims—but he has twice fought to get big tax cuts. This is a president whose eyes are wide open to the short and long-term fiscal and policy implications of the revenue losses he has imposed on the federal government. Even as he has truncated the budget horizon from 10 to 5 years², he is aware of the doomsday projections that if current policy continues, a generation from now, social security and Medicare will claim almost all of the federal revenue, leaving very little for the rest of government. He wants to strip the government of future revenue, not in spite of these dire scenarios but because of them. He

sees revenue privation as the only or best weapon to change the course of budgetary history, a history that for him probably began with Reagan's victory in 1980. Bush is an avid student of recent political failures, in particular his father's failed presidency and the failure of both Reagan and his father to halt the expansion of government.³ George W. Bush wants a smaller government, and he's willing to pay the budgetary price to get it. In contrast to Reagan, he has not launched a rhetorical challenge to big government, preferring instead to let budgetary realities do the job for him. In contrast to his father, George W. Bush is not willing to let adverse budgetary numbers get in the way of his determination to purge the government of revenue. The elder Bush said, "read my lips, no new taxes" and signed a large tax increase into law. The younger Bush does not want to repeat his father's backpedaling. In contrast to both Reagan and his father, Bush had a Republican Congress through most of his first term, making it much easier to muscle his tax cuts through the House and Senate.

At times, the White House trots out its version of the "it's the economy" defense to argue that the deficit has been the product of economic force majeure, that the rising tide of red ink has been caused by the plunging stock market and fragile economy, not by policy changes. This "no-fault" defense does not square with the facts, however. Critical turning points in budgeting—from deficits to surpluses in the 1990s and back to deficits in the present decade—did not just happen; they were driven in substantial part by changes in federal revenue or spending policy. For Bush, no less than for his predecessors, policy matters in budgeting. Moreover, policy mistakes—and this writer considers the current fiscal posture a colossal misstep—take a long time to wash out of the federal budget. It took the federal government 28 years (1970-98) to produce a surplus, but only 4 years to return to deficit. The asymmetry in budget cycles is due to policy biases, not to economic swings. It is far easier for politicians to

cut taxes than to raise them, and far easier to boost spending than to curtail it. Economic weakness impels the government to spend more than it takes in; economic strength also impels it to spend more, though not necessarily more than the revenue it produces. At this point, no one knows whether the nation will go through another 28-year spell of deficits, but it is not too early to predict that the government will not be able to liquidate annual deficits if it stays on the current budget course.

Bush is a president who has learned from the recent past and is looking to change the future, and is willing to risk the present to accomplish his aims. He has been told that discretionary spending will go up a lot more than his official forecast shows, that his proposal to allocate \$400 billion for Medicare prescription drug coverage will not suffice, that in the next decade, social security surpluses will diminish, and that before 2020 Medicare will be insolvent. He knows that spending on homeland security and national defense will soar tens of billions above budgeted level, and that the new Bush doctrine of preemptive war will be costly. But instead of conceding the need for a more robust revenue base, Bush firmly believes that only a vastly larger, perhaps unmanageable deficit can curb the relentless expansion of government.

Thus, the Bush White House is not clueless on the fiscal course the president has charted; this is not a case of ignorance aforethought. The administration knows what it wants and is setting out to get it. Bush's revenue policy is actually a spending strategy. He wants revenue deprivation to force a truly fundamental change in the course of government. Rather than tinker with social security and Medicare so that they can muddle through a few more decades, Bush wants the government to be so depleted of resources that it cannot come to their rescue. Rather than fight and lose on appropriation bills, Bush wants Congress to come to its own realization that the spending culture of Capitol Hill has to be purged.

During the Reagan era, to which the Bush presidency is sometimes compared, serious policy mistakes led to a fourfold increase in the federal debt held by the public from \$700 billion in 1980 to \$3 trillion in 1992. At the time, Senator Daniel Moynihan accused the administration of fabricating the deficit to starve the government of revenue. Moynihan did not have a smoking gun to validate his accusation, but George W. Bush has supplied one. Several weeks after taking office, Bush unveiled his “Blueprint for New Beginnings” which set forth his budget policy. One of the charts in this publication is prominently titled “Budget Surpluses Lead to Bigger Government.”⁴ The chart noted the surge in discretionary spending that occurred when surpluses emerged in the late 1990s. According to the Bush worldview, since surpluses inevitably spur government to spend more, the sensible thing to do is to get rid of surpluses. Otherwise, government will grow bigger, regardless of whether the Democrats or Republicans are in command. Many conservatives accept as an article of faith that no matter what rules are applied, a significant portion of the revenue raised to abate the deficit will be spent instead on enlarging government. The critical turning point in their thinking came in 1982 when Ronald Reagan undid some of the tax cuts enacted the previous year by agreeing to a deficit reduction package that he thought would subtract 3 dollars in federal spending for every dollar added in revenue. When few of the expected spending cuts materialized, Reagan and fellow conservatives felt cheated. This was “The Triumph of Politics” bemoaned by David Stockman who understood that Americans and their elected leaders, including many Republicans in Congress, want to spend more, not less.⁵ Despite his misgivings, Reagan signed another half dozen, mostly minor, tax increases into law during his long presidency.⁶ But the biggest blow to conservatives came in 1990 when the first President Bush agreed to legislation boosting the

highest marginal tax rate on individual income as part of a half-trillion dollar deficit reduction package.⁷

Two decades after Reagan signed his first tax increase and one decade after President Bush signed his only increase, the lessons have been branded into the political mindset of conservatives and have framed George W. Bush's budget policies. One lesson is that it is better to have a smaller government with a bigger deficit than a bigger government with a smaller deficit. Another lesson is that the political system and the budget process are biased in favor of more taxes and more spending. In the eyes of many conservatives, the expansionary bias of politics arises out of the simple fact that the cost of programs are dispersed among taxpayers while the benefits are concentrated among those who get the services or payment from government. As a consequence, those who want smaller government in principle nevertheless promote the expansion of government by lobbying for particular programs.

The biases of the budget process also favor government expansion. According to conservative ideology, the appropriations committees buy support in Congress for higher spending by earmarking funds to Members, and the congressional budget process propels higher expenditure by incorporating price and (for mandatory programs) workload changes into the official projections that are used to measure the impact of executive and congressional actions on federal revenues and expenditures. The budget rules that were enacted to combat these biases—the Gramm-Rudman-Hollings (GRH) limitation on deficits in the 1980s and the Budget Enforcement Act (BEA) restrictions on tax and spending legislation in the 1990s—did not, in the view of conservatives, have the intended effects.⁸ In each year that GRH was in effect (1986-90), the actual deficit exceeded the limit permitted in law. And, despite the BEA caps on appropriations and PAYGO rules for mandatory programs, federal spending continues to rise.⁹

If politics and budgeting expand government and restrictive rules do not counter the trend, the only recourse is to put the federal budget in a predicament that precludes significant expansion. This is the “starve the beast” strategy that defines George W. Bush’s budget posture. Of course, to him and other conservatives, this means cutting revenues before expenditures, and thereby leaving the government with record deficits until such time as the imbalance compels the contraction of government. Conservatives disagree on whether deficits matter, but many who believe it does think that the alternative—the relentless growth of government—matters even more.

This chapter provides an interim assessment of the Bush strategy. No presidential term ends quite the way it began, certainly not one beset by terrorism at home, a costly war abroad, and an economy struggling to recover from post-bubble trauma. Compared to his recent predecessors, Bush seems the type who values staying the course. It will be difficult to dislodge him from entrenched budget positions, no matter how severe the imbalance between revenues and expenditures. Nevertheless, the longer he is in office, the weaker claim Bush’s original budget doctrine will have on his political calculations.

The next section focuses on spending policy because it is the key to understanding Bush’s hard line on taxes and his willingness to have oversized deficits. Section 2 turns to the revenue side of the budget and considers trends in tax collections and the distribution of the tax burden. Distributive questions are critical to the Bush agenda because he inherited a tax structure that virtually assures that upper-income persons are the principal beneficiaries of tax cuts. Section 3 examines the deficit that has ensued from Bush’s budget policies in the light of current and prospective economic conditions. The final section discusses the politics of the President’s

budget strategy, in particular his dependence on congressional approval. It concludes with speculation on whether the Bush strategy will survive beyond the Bush presidency.

1. Cutting Expenditure By Indirection

As a president who wants to reduce the size of government, George W. Bush is reticent about where most of the cuts will fall. In contrast to his father and Ronald Reagan who listed many of the programs that were to be terminated or curtailed, the President veils his cuts in projections that show appropriations rising about as fast as inflation during his hoped-for two-term Administration, and promises new money for Medicare and some other entitlement programs. One must plumb the budget's accounts to find the many programs that will grow less than inflation or that will lose resources through various reforms. Few of the cutbacks are so dramatic as to provoke a "dead on arrival" verdict that accompanied the budgets of his Republican predecessors. If Bush has his way, during his presidency many programs will be scaled back simply because there is not enough money to go around, not because he has launched a frontal attack on government.

For example, the 2004 budget proposes to give states the option of switching their Medicaid programs to a block grant. States that switch would get increased funding; those that don't would continue with the existing matching grants, but they would not receive any of the \$13 billion increase. However, increased spending would be available only for seven years; afterwards, federal Medicaid payments would drop significantly below levels prescribed by current law. But inasmuch as the Bush budget shortened the time horizon from 10 to 5 years, only the increases appear in the budget.

Bush knows that although efforts to shrink government may have some short-term success, over the long run, the spenders win out. Evidence for this conclusion can be drawn from

Table 1, which shows discretionary spending at 4-year intervals since 1965, the year before the Great Society irrevocably enlarged the federal government. The 4-year intervals approximate presidential terms, but inasmuch as the fiscal and budget calendars are not in sync; the figures in the table do not precisely show the spending changes that occurred during each presidential term. The table reports spending in both current and constant (1996) dollars and as a share of GDP. It also distinguishes between defense and domestic discretionary spending, that is, spending controlled by annual appropriations decisions. These appropriations account for only a little more than one-third of federal spending, but this is the portion of the budget that requires annual congressional action. The remaining expenditure is mandatory, mostly entitlements and interest on the public debt. Some of these have permanent appropriations that become available automatically; others require annual appropriations, but the amount spent is controlled by substantive legislation.

Budget conservatives view the trends in this table as confirming runaway government expansion. In fiscal 1965, the last year before the Vietnam War buildup, defense appropriations were more than double those for all domestic programs. By 2000, however, domestic appropriations exceeded defense spending. Much of this shift in relative spending occurred in the 1990s, after the cold war ended but before 9/11 triggered a new upsurge in defense spending. Defense poses a dilemma for Bush's objective to shrink the size of government; in thinking that the federal government has grown too large, he clearly has domestic programs in mind, but he knows that defense spending opens the door to more domestic spending, first, by building support for tax increases, second, by having domestic spending displace defense appropriations when the threat to national security recedes. This "displacement effect" is one of the leading explanatory factors in government expansion in democratic countries, and it has been a recurring

pattern in American budgetary history.¹⁰ If past trends continue, the surge in defense spending during the Bush Administration will facilitate a big expansion in domestic programs some time in the future. To ward this off, Bush is not paying for additional defense spending with tax increases, as was the case in most past military engagements. Moreover, he has been somewhat tight-fisted in supplementing defense appropriations, resisting demands from military leaders for more resources. In fact, Bush has augmented the defense budget much less than Reagan, to whom he is sometimes compared, did two decades ago. Reagan boosted defense spending from 4.9 percent of GDP in 1980 to a peak of 6.2 percent in 1986; the Bush scenario (which excludes the war in Iraq) projects defense outlays declining from 3.5 percent of GDP in 2003 to 3.3 percent five years later. Perhaps Bush is a skinflint who dislikes spending any money, perhaps he has been indoctrinated by Vice President Cheney and Secretary of Defense Rumsfeld in the view that the best way to get military leaders to restructure the armed forces is to squeeze them on money. But it also is likely that Bush is wary of pumping up defense too fast lest Congress siphon off some of the money for domestic priorities.

This pattern is clearly evident with regard to homeland security, Bush's most prominent government initiative. Immediately after 9/11 and in both regular and supplemental appropriations bills, Bush strongly opposed efforts by congressional Democrats and some Republicans to provide more money for "first responders" and other state-local security-related activities. At first glance, this seems an easy call for Bush: give state and local governments enough to at least reimburse their out-of-pocket security costs. Bush, however, clearly sees this as a domestic spending issue; he is convinced that giving states and localities money labeled "homeland security" will enable them to spend more on ongoing activities that have little to do with making the nation more secure.

Bush's parsimony has surprised some who expected his experience as Texas' Governor to sensitize him to the fiscal plight of many states whose budgets have been severely imbalanced by the economic downturn and other adversities. His failure to help the states wells out of an overriding concern: the added expenditure would enlarge both the federal budget and state governments. The President views state deficits the same way he views the new federal deficit, as an opportunity for the states to curtail spending. If they don't, it's their problem, not the federal government's.

Bush knows that it is hard to curtail spending, as a review of the trends in Table 1 indicates. In nominal terms, domestic appropriations rose almost 20-fold, from a little more than \$20 billion in 1965 to \$400 billion less than 40 years later. The rise was relentless, in every presidential term, regardless of whether a Democrat or Republican occupied the Oval Office. The fact that domestic appropriations are about the same share of GDP today as they were before Great Society programs, environmental protection, and many other activities were added to the roster of federal responsibilities does not alter the conservative view that government cannot control its appetite to spend public money. Spending as a proportion of GDP may be the way economists analyze budget trends, but it is not the metric favored by politicians bent on making the case that government has grown too large. The same mindset pertains to real (inflation-adjusted) expenditure which grew 3-fold during the past four decades. Conservatives regard inflation adjustment as one of the key weapons used by spenders to wrest more money from the budget. Although their protests have been to no avail, conservatives believe that CBO's use of an inflated baseline has contributed to the enlargement of government because nominal spending increases below the inflated baseline are labeled as spending cuts.¹¹ The conservatives may have

a valid point here, but they do not apply it consistently. If they had their way, defense spending would be adjusted for inflation, all the rest would not.

As a student of recent political history, Bush has been most influenced by spending patterns during the three presidencies that immediately preceded his. Reagan succeeded in downsizing real discretionary spending, principally through blitzkrieg victories during his first year in office. But Reagan's successes were not lasting, and by 1996, less than a decade after he retired, real spending was above the level he inherited at the start of his presidency. How and why did this happen? Bush and fellow conservatives are certain that the large tax increases enacted in 1990 and 1993 fueled the re-growth of government. Rather than paying down the deficit, which is the way economists generally view the tax increases, conservatives argue that they opened the door to bigger government.

To George W. Bush and fellow conservatives, the most telling evidence of fiscal laxity occurred during his father's short presidency. In the elder Bush's single term, the rise in domestic appropriations averaged more than 7 percent a year, almost double the rate during the ensuing Clinton presidency. When George H. W. Bush was defeated, annual appropriations for domestic programs were almost \$60 billion more than when he was elected. Worse yet, Bush began his term with Gramm-Rudman-Hollings rules (first enacted in 1985) restraining the deficit and ended his term with Budget Enforcement Act rules (enacted in 1990) restraining appropriations. Evidently, neither worked; GRH failed because it targeted the projected rather than the actual deficit, thereby enabling politicians to assume more favorable conditions than were warranted; BEA failed because it capped domestic appropriations at a high level, allowed politicians to evade the limit by labeling expenditures as emergencies, and (in some years) permitted the substitution of domestic appropriations for defense spending.

This is not the full BEA story, however. In terms of constraining federal spending, BEA went through three distinct phases. It was not effective either during the first phase (the period immediately after its enactment) or during the final phase (the last years of Clinton's presidency and the first year of George W. Bush's term). It did not constrain domestic spending at the outset because the Appropriations Committees obtained a large, upfront increase in spending in exchange for accepting the caps; it was not effective at the end because the arrival of large surpluses unleashed spending demands in the White House and Congress. But it was effective through most of the Clinton presidency; real discretionary domestic spending was less than 1 percent higher in 1998 than it had been in 1994. The rules worked, but only after the caps had been set at a high level and before the surpluses loosened budgetary discipline. However, it was not Clinton's relative parsimony but his father's failure and the spending spree that welcomed him to the White House that framed George W. Bush's budget outlook.

During the first years of his presidency, Bush has been unable to escape the impact of Clinton's last years. Clinton bequeathed his successor spending momentum that has not been significantly dampened by 9/11 and the return of big deficits. To illustrate Bush's problem, let us assume that he had been elected in 1998 rather than two years later. On taking office, discretionary domestic outlays would have been \$277 billion; in fact, however, they were \$321 billion, almost \$50 billion higher, reflecting the disregard of BEA rules triggered by the surplus. The rules remained in place, but political behavior had changed. More importantly, the spending mood continued unabated with the presidential transition. Bush's first budget for fiscal 2002 requested for domestic appropriations, but by the time the fiscal year had ended, these outlays totaled \$359 billion. The same pattern was repeated in the next two years, spurred by the funneling of additional resources into homeland security. Fiscal 2004 discretionary domestic

outlays are currently projected to be more than \$400 billion, compared to less than \$300 billion in fiscal year 2000.

Why doesn't Bush just say no to more spending? The straightforward answer is that he can't; possibly because spending pressures are too intense. He succeeded in Texas by agreeing to more expenditure than he professed to want, but that state is reputed to have the weakest executive budget system in the nation. The legislature rules in Texas, and Bush got along by going along, sometimes reluctantly. Like most Americans, Bush wants smaller government but bigger programs, and while he has challenged Congress on budget matters, appropriations usually end up more than he asked for. This is exactly what happened in the tug of war between Bush and Congress over fiscal 2003 appropriations. Because of conflicts and delays in House and Senate action, 11 of the 13 regular appropriation bills were folded into an omnibus act that was passed in the fifth month of the fiscal year. Despite the fact that Bush and Republican leaders agreed that regular appropriations for 2003 should not exceed \$751 billion (in budget authority) the omnibus act resulted in a \$766 billion total.

CBO has estimated that this increase added \$200 billion in baseline projections of discretionary outlays over the next 10 years. Other provisions in the omnibus appropriations act affecting agriculture and Medicare are estimated to boost mandatory spending by more than \$50 billion over the next decade. With higher debt-service costs added, this single act increased baseline projections of future deficits by more than \$330 billion.¹²

The omnibus experience is important in understanding Bush's budget problem because he announced a top line that he would not cross and then breached it. He did not have the personal or political strength to just say no. He has the same problem with mandatory spending, which Table 2 discloses, has had much larger increases during the past three decades than those

achieved in the discretionary budget. Inasmuch as mandatory spending is driven by eligibility rules and payment formulas written into substantive law, most of their increases are automatic; they occur without new congressional action and regardless of the President's budget preferences. Bush wants to slow the growth of some mandatory programs by inducing the states to convert them into block grants rather than open-ended entitlements. Thus far, Congress has not adopted any of his proposals, but if it were to do so, the legislation would likely hold states harmless against a loss of federal aid and might also offer "sweeteners" in the form of additional up front grants to encourage the conversion.

The federal budget will continue to be dominated by entitlements as far ahead as the eye can see. At times, some entitlements may be adjusted at the margins, but the role of the government in assisting dependent families and households will not diminish significantly. The easy course for Bush, therefore, is to accommodate his budgets to these expenditures. Two problems, however, preclude doing nothing; one is that medicare and social security cannot be endlessly sustained in their current form; the others is that despite deficits, Americans want the government to spend even more on certain entitlements than current law requires. Before 9/11 and the return of big deficits, Bush was laying plans to makeover social security by shifting much of its financing into private accounts. He hoped to use a portion of the \$5.6 trillion surplus projected at the start of his administration to finance the cost of transitioning to a partly privatized social security system. When the surplus vanished, the President stopped promoting social security reform because the government lacked the funds to pay for it. Medicare, however, has remained on the table, both because its financial crisis will come much earlier than social security's and because pressure has built to extend coverage to prescription drugs. Bush has tried to straddle the conflicting medicare pressures by linking reform and expansion, but he

has run into criticism from those in his own party who believe that all eligible seniors should receive prescription drug coverage, even if they elect to stay in the traditional fee-for-service system. Moreover, Bush has been impelled to propose \$400 billion more for prescription drug coverage, more than his original offer, but only about half the amount sought by congressional Democrats.

If medicare is a harbinger, the federal government will spend proportionally more on entitlements in the future, not less. A frontal attack on popular entitlements would injure Republican prospects at the polls; accommodating Democratic demands would further enlarge the federal budget. The difficulty of cutting entitlements is illustrated by the medicare increases enacted in the 2003 omnibus appropriations measure. Some years ago, Congress ordained the medicare payments to physicians would be cut by 4.4 percent in March 2003. But under pressure from medical groups, the omnibus bill cancelled the cut, adding more than \$50 billion to baseline expenditure over the next decade.

Bush's budget problem is a spending problem. But his solution is not on the spending side of the budget. To spend less, Bush is convinced that the government must tax less, which is what he has set out to do through tax cuts enacted in 2001 and likely to be enacted in 2003.

The Power Not to Tax

"Taxation," Richard Rose and Terence Karran wrote, "precedes big government. The development of the capacity to collect large and increasing sums of money in taxes has been a necessary condition of the growth of government."¹³ This unsurprising conclusion was drawn for the British Government, but it fits the United States and every other industrial democracy as well. The expansionary process has a certain circularity: government runs an actual or projected deficit, raises taxes to cover the shortfall, spends more because it has more to spend, returns to

deficit, and raises taxes again. A generation ago Martha Derthick chronicled how social security tax rates, which were set at 1 percent of covered payrolls when the program was established in 1935 soared to more than 6 percent by the 1980s.¹⁴ Congress periodically expanded social security benefits, its actuaries then projected a future deficit in the system, Congress raised rates a bit more than was needed to cover the deficit, the new funds permitted a further expansion in benefits leading to deficit, and the process repeated itself.

Bush wants to break this pattern by cutting taxes rather than raising them. He succeeded in 2001, getting Congress to approve almost \$1.3 trillion in tax cuts over a 10-year period. The main features included progressive reductions in marginal tax rates, a rebate to taxpayers, and phase out of the estate tax. The estimated cost was held down by budget rules that impelled Congress to make some tax cuts temporary, in the expectation that they would be made permanent in subsequent legislation.¹⁵ Fully effective, the cuts would total almost \$2 billion over the next decade and more in the years beyond that. Bush returned to his tax cutting strategy in 2003, proposing \$726 billion in reductions over the next decade, centered on eliminating the tax on dividends and accelerating some of the cuts enacted two years earlier. In addition, he asked for a steep increase in the amount Americans shelter in tax savings plans. The President's short-term success can be measured by the Democratic response, which proposed to cut the revenue loss to about \$350 billion.

In the context of revenue trends over the past several decades and the projected revenue needs for the next several decades, the 2003 tax cut makes no sense. President Bush's fiscal 2004 budget estimated that, assuming his tax cuts were enacted, federal receipts in that year would be 17.0 percent of GDP, below the average of any decade during the post World War II period. Federal revenues have not been as low as 17.0 percent of GDP since 1965, the last year

before the cost of Great Society legislation impacted the budget. The reversion to 1965 revenue levels may be coincidental, but the aim to force the shrinkage of government is not. Looking ahead to future demands on the budget, paring revenue barely a handful of years before the leading edge of the baby boom generation begins to draw promised benefits appears to be a willful disregard of financial realities. It has been estimated that federal spending on social security, Medicare, and Medicaid (a rising portion of which goes to assist elderly Americans) will double from a little more than 7 percent of GDP at the turn of the century to 14 percent by 2030 and 20 percent by 2070.¹⁶ This projection assumes that the current structure of federal pension and health financing programs will remain intact, which is precisely the point that divides those who see tax cuts as imprudent and those who want more of them. One side argues for tax increases because the government will not have enough money to pay the benefits; the other side argues for tax cuts to emphasize that the promised benefits are untenable. In the latter view, the less money the government has, the more evident it will be that fundamental changes are need in public policy.

In addition to stirring controversy on fiscal grounds, the Bush cuts have stirred controversy over their distributive impacts. Most of the tax reductions enacted in 2001 and 2003 accrue to upper-income earners. One reason for this is that changes in the distribution of income and in the progressivity of the income tax during the 1990s decreased the tax burden of low-income Americans while significantly raising the tax liabilities of upper-middle class and affluent households. Drawing on IRS data, the Tax Foundation has calculated that the top 10 percent of taxpayers accounted for two-thirds of individual income tax receipts in 2000, up from one-half in 1984.¹⁷ The bottom half of taxpayers contributed only 13 percent, down five percentage points from their share in the 1980s. This skewed distribution of the tax burden

dictates that across-the board tax cuts, such as reductions in marginal tax rates, have much greater dollar value for affluent persons than for poor ones. Moreover, most (the earned income tax credit is an exception) are not refundable; the credit is limited to the amount of tax liability. Thus, persons who already pay little or no taxes, get little or none of these breaks. In fact, millions of Americans did not get the rebates distributed in 2001 because they did not pay income taxes.

Basing his position on the argument that tax cuts should go to those who pay taxes, Bush tilted both the 2001 and 2003 reductions in favor of upper-income Americans. They would be the main beneficiaries of phasing out the estate and dividend taxes and expanding tax sheltered savings plans. It has been estimated that a family of four would be able to shift \$60,000 a year to these savings plans. This amount exceeds median family income and would be available only to households whose income enabled them to save a substantial portion of their earnings.

Regardless of the merits of Bush's position, it may turn into an economic and political liability, and certainly impedes efforts to restore budgetary balance. Bush promoted tax cuts in 2003 as necessary to spur economic growth, but tax cuts to low-income earners have greater stimulative potential than those awarded to upper-income taxpayers. The latter typically increase savings when their taxes are cut, the former increase consumption. Bush does not have to worry about a political backlash if he remains popular, but if the economy continues to languish and the Democrats are able to mount a strong challenge, the concentration of tax cuts on affluent Americans may damage him at the polls. To cover his political flanks, Republican's broke with doctrine in 2003 and made the expanded child tax credits refundable; it goes to persons who pay little or no taxes.¹⁸ Inasmuch as the refundable portion of a tax credit is scored as outlays, this facet of Bush's drive to cut federal revenue increased federal spending.

The distribution of the tax burden troubles many conservatives who believe that it encourages American who pay little or no taxes to demand more from government. Liberals counter that low-income earners pay a disproportionate share of social security taxes, and that the maldistribution of the tax burden merely mirrors the maldistribution of income in the United States. This is a debate that has no end, for the history of the income tax indicates that policy swings in one direction, then in another. Bush's tax cuts for the affluent are a reaction to the tax increase imposed on this segment of the population in the 1990s. At some time in the future, taxes will be boosted on upper-income persons in response to the Bush cuts.

Until this occurs, however, the budget may have to bear the brunt of a tax code that collects little from the bottom-half of income earners and much less than before from those at the top of the income ladder. If estates, capital gains, dividends, and savings escape taxation, or pay reduced rates, the main burden will fall on wage earners who make too much to avoid taxes and too little to evade taxes. This will not be fiscally or politically tenable: the government will not collect enough to pay its bills, and middle-income Americans will pay too much to tolerate their tax bills.

The Economic Deficit

The budget deficit has not been due solely to Bush's tax cuts; it also is the result of a weak economy that has been buffeted by collapsing stock prices, a fall in business investment, and the adverse effects of terrorism and war on consumer confidence. The early signs of weakness appeared during the last half-year of the Clinton presidency when real growth slowed to barely a 1 percent annual rate. Bush, however, will be judged, both by contemporary observers and in historical perspective not by the economy he inherited, but by the one he managed. Halfway through Bush's first term, there already is reason to be concerned about the course of

economic policy. Part of the concern is short-term: is the President doing the right things to lift the economy out of the doldrums? Surprisingly, however, much of the controversy over Bush's policies pertains to the country's long-term prospects; has the President embarked on a course that will impair the future economic performance of the United States? Tension between short and long term considerations is centered on the budget deficit. While it may ease the current economic malaise, if the deficit persists, it may lower the economy's potential in the decades ahead.

Bush is not a fan of the economic fine-tuning that was in vogue during the heyday of Keynesian doctrine a generation ago. Like other supply-siders, he believes that active demand management contributes to the progressive enlargement of government. In this view, the size of the deficit doesn't have much influence on economic development. The deficit does not do much good in the short run, and it does not damage the economy in the long run. What matters is not the size of the deficit, but the structure of federal taxes and expenditure. The budget aggregates have little economic meaning of their own; they are merely the resultants of the numerous features of the tax code and of public expenditure that encourage or discourage work, saving, investment, and profits. Taxes on the inter-generational transfer of wealth are prominent provisions of tax policy that inhibit economic activity. On the spending side, an over-generous welfare state and the shift of risk from households to government have undermined the vitality of the United States.

The argument that deficits do not matter explains the startling abandonment by Bush and many fellow Republicans of the Party's traditional anti-deficit stance. Clearly, there is residual unease in Republican ranks about deficits that may approach or exceed \$500 billion a year if bad-case scenarios materialize. Yet, the President does not defend the deficit on the ground that

it will ease economic distress. His 2003 Economic Report makes the case that the deficit has been caused by economic weakness and other factors; it does not claim that recovery will be stimulated by the deficit.¹⁹

In this construct, the relationship between budget aggregates and the macroeconomy is unilateral. A weak economy causes the budget to spiral into deficit; a deficit does not cause the economy to grow any more than a surplus does. This posture explains why Bush waited until January 2003, more than two years after the economic slowdown began to announce a stimulus program. Of course, the stimulus package consisted almost entirely of tax cuts, and of course, the cuts were justified on the ground that they would generate jobs. Democrats and many economists pointed out that the new round of tax cuts would provide little immediate stimulus, and that substituting rebates for low-income persons would have greater short-term impact than would eliminating the dividend tax or provisions enabling affluent persons to protect savings against taxation.

While the immediate economic impact of Bush's tax program is problematic, the long-term implication has troubled many economists who see it as a ploy to deplete the treasury of sufficient resources in the future. Controversy over long-term effects parallels the short-term arguments. Critics see chronic deficits as jeopardizing the future economic well-being of the United States; Bush sees them as irrelevant, believing instead that the tax structure matters more than the capacity of revenues to cover expenditures. The Democratic argument, which has been labeled "Rubinomics" after Clinton's influential Secretary of the Treasury, is based on the notion that a robust economy requires a pool of savings to permit investment and productivity gains. Because Americans do not save much, this pool depends on the federal government saving for them by running a budget surplus. If, however, the government were to incur chronic deficits, its

dis-savings would further shrink what is already an inadequate pool of financial resources needed to assure future economic growth. Here, too, the Republicans riposte is that deficits do not matter, that future savings depend on incentives built into the tax code. They further argue that the high marginal tax rates enacted in the 1990s, along with the long-standing tax on dividends and other established features of U.S. tax policy account for the low level of savings. Thus, even if certain aspects of Bush's tax cuts will not bring much immediate stimulus, they will promote future economic growth.

In one sense, this is a clash of economic beliefs, neither of which can be truly validated without the passage of years or decades. If the Democrats prove to be right, the economic potential built by having ample savings can cumulate to trillions of dollars of additional GDP over the next half century, enough to finance social security and other downstream commitments. If, however, the Republicans are right that aggregate budget savings do not make much of a difference but that eliminating disincentives to save embedded in tax policy would, their plan would pave the way for a more prosperous future. Unfortunately, however, policy cannot wait until the evidence is in, nor can politicians afford to make big mistakes. This is an area where taking the wrong turn may seriously damage America's economic health. Prudence dictates that we not pave the way to the future with trillions of dollars in additional debt.

In another sense, the conflict between Republicans and Democrats is not about the future or over policies to stimulate savings, but over current and future expenditure. One side wants government to have sufficient resources to finance ongoing programs plus some enhancements; the other wants it to have insufficient resources, so that it will be compelled to retrench some commitments. Democrats and Republicans are fighting over today's government and tomorrow's is at stake.

The Budget Battle in Congress

Not only are the two parties warring over budget policy; Congress has the final word, not the White House. Bush has prevailed by pushing his budget agenda through a Congress in which Republicans have a bare majority in each chamber. They have little margin for defection and little prospect of gaining Democratic support. The Democrats are united in opposition, so Republicans must rally behind their President for him to win. This is an age in which party line voting is near a record high, and the budget has become one of the great divides between the two parties. Bush has had easy passage in the House where the rules favor the majority party and enable it to control floor debate by denying the minority the opportunity to offer amendments. As long as House Republicans are cohesive, they have the votes to pass Bush's budget program. The situation is more difficult in the Senate where party discipline is weaker and the Democrats can block action by filibustering any tax cut that exceeds the amount provided for in the budget resolution.

Tax policy is one of the few issues that unites Republicans; spending, by contrast, divides them. Some Republicans, however, are troubled by the massive deficits that looking ahead, and they would be willing to defer some of Bush's second round of tax cuts until the budget outlook brightens. Consequently, Bush and Party leaders in Congress have to whip wavering members into line by offering standard legislative inducements such as favorable consideration of tax breaks or expenditure earmarks. But the main inducement has been the old fashioned appeal to rally behind the President in time of national crisis. The Bush White House has artfully turned terrorism and war in Iraq which have added over \$100 billion to the annual deficit into an argument for enacting tax cuts that would add hundreds of billion more. The budgetary

arithmetic may not add up, but the political calculus gave the President a winning hand in Congress.

As impressive as Bush's congressional victory was, it required difficult negotiations between the House and Senate, tie-breaking votes by the vice-president, budgetary ruses that veiled the true cost of tax reductions, and efforts to keep the small numbers of Republican doubters in line. Both the 2001 and 2003 revenue measures had to go through two legislative processes: (1) a budget resolution that set the outer limits of revenue loss as measured by current budget rules; and (2) a reconciliation bill that enacted changes in the tax code. Failure at either of these stages, or in either the House or Senate would have doomed the President's agenda. Moreover, for Bush to prevail the House and Senate would have had to set aside fundamental differences in political makeup and style and agree on a single measure.

During the 1970's, in the aftermath of Watergate and Vietnam, Congress introduced the budget resolution process as a means of staking out an independent position on revenues and expenditures. The President was given no role in the budget resolution; he can neither sign nor veto this measure. It is an internal congressional device, and Congress is not bound to follow the President's lead. As things have turned out, however, the budget resolution serves two very different purposes than those foreseen by its original architects. One is to facilitate passage of the President's budget agenda; the other is to facilitate enactment of a reconciliation bill. Bush, like Reagan and Clinton before him, took control of Congress' own budget apparatus and made it into an instrument of presidential policy. Bush might have won even without a budget resolution endorsing tax reduction, but in view of Congress' congenital fragmentation, the battle would have been more difficult.

Nowadays, just about the only purpose served by the budget resolution is to set the stage for a reconciliation bill, which is protected against a Senate filibuster.

With reconciliation, the President's tax plan is assured of passage if he can muster majority support in both the House and Senate; without reconciliation, it can make it through the House, but has no chance for passing the Senate. But to be a reconciliation bill, Congress must first pass a budget resolution that contains reconciliation instructions and determines the amount of revenue loss that is protected against a filibuster. Thus, the key vote on the President's budget policy occurred in the budget resolution, even though enactment was in separate measures. In 2001, with the Senate divided 50-50 before Senator Jeffords switched party affiliation, the Senate passed Bush's big tax proposal virtually intact because it was in a reconciliation bill. In 2003, the budget resolution reduced the amount set aside for tax reduction, assuring a tax cut, but not as much as Bush had requested.

The official size of the 2003 tax reduction was further constrained by defection of several Senate Republicans. While much has been made of the split in Republican ranks, the more important story has been the high degree of cohesion. True, in a closely divided Senate, even in a few defections can put the majority party at risk, but it is also true that Bush got most of what he wanted because almost all Senate Republicans stood with him. Arguably, with the full effect of the sunsetted provisions counted in, Bush got more than he bargained for. Tax reduction in 2003 demonstrated that in budgeting less could be more.

Why Bush May Lose Even Though He Won

"This ain't the end of it—we're coming back for more", House Majority Leader Tom Delay said shortly before the House voted final approval to the 2003 tax cuts.²⁰ News accounts

told of a Republican strategy to make tax reduction an annual occurrence, to both extend sunsetted provisions and cut some other taxes as well. As long as Republicans control both the legislative and executive branches and are united, they can continue to shrink the government's revenue base. Ultimately, however, tax reduction must be coupled with spending reduction; if it isn't, the imbalance in the budget will unbalance Bush's budget objectives.

The coupling of the two sides of the budget was openly displayed in the budget resolution adopted by the House in 2003. Not only did it accommodate the full \$726 billion in budget cuts requested by Bush, it spelled out the spending cuts that would restore the budget to balance within the 10-year period covered by the resolution. According to the Center on Budget and Policy Priorities, the resolution would prune an estimated \$475 billion from discretionary spending, Medicaid, and certain entitlements.²¹ These amounts are calculated against the CBO baseline and would be phased in over the 10-years. With much smaller tax cuts, the Senate version also had more modest spending cuts.

There are critical differences between the proposed tax and spending cuts, however, which leaves open the strong probability that enacting the former will not ensure approval of the latter. One difference is that tax reductions are enacted up front in a single measure; appropriations cuts must be enacted one year at a time. Entitlements reductions can be enacted upfront, but when they are, there is a good chance that they will be reversed, as occurred to reduced payments to physicians that were supposed to become effective in 2003.

An even more important difference between the revenue and spending sides of the budget is that Republican Party unity is much more pronounced in taxes. While barely a handful of congressional Republicans have deviated from the party line on taxes, many more have done so on spending issues. Of course, almost all Republicans (and many Democrats) espouse the view

that the federal government should be smaller and should spend less, when particular programs are up for a vote, they find it difficult to say “no”. In this regard, many congressional Republicans mirror George W. Bush; they would like to spend less, but lack the political will to resist demands for more money. In 2003, the tax reduction law added \$30 billion to federal spending in order to attract the votes needed for Senate passage. Thirty billion is not a lot of money in the federal budget, but it does couple tax reduction and spending increases, the exact reverse of Bush’s strategy.

Thus, the probability is that Bush will meet the same fate that Ronald Reagan did two decades earlier. He will be largely successful on tax matters, but much less so on spending policy. And just as Reagan’s success on revenues and failure on spending opened the door to massive deficits “as far ahead as the eye can see” in David Stockman’s famous words, so too will Bush’s successes and failures. Just as Reagan was succeeded by presidents who boosted taxes, so too, will George W. Bush. It does not even matter whether his successor is a Republican or a Democrat; taxes will be increased. The only way for him to thwart a future president from pushing tax increases through Congress would be for Bush to do so himself. But then he would be more like his father than he wants to be.

Table 1
DISCRETIONARY SPENDING TRENDS 1965-2008
(dollars in billions)

	<u>Defense</u>			<u>Domestic</u>		
	Total	Constant\$	%GDP	Total	Constant\$	%GDP
1965	51	267	7.4	22	119	3.2
1969	83	362	8.7	31	131	3.2
1973	77	257	5.9	49	161	3.7
1977	98	231	4.9	92	220	4.6
1981	158	260	5.2	136	236	4.5
1985	253	331	6.1	145	208	3.5
1989	304	370	5.6	168	212	3.1
1993	292	316	4.5	225	245	3.4
1997	272	266	3.3	257	252	3.1
2001	306	276	3.1	321	287	3.2
2005 est	410	347	3.4	412	342	3.5
2008 est	460	375	3.3	433	339	3.1

Source: Budget of the United States Government, Historical Tables, Tables 8.1, 8.2 and 8.4.

Constant dollars are in FY 1996 dollars.

Table 2
GROWTH IN MAJOR ENTITLEMENT PROGRAMS
(in billions of dollars)

	1970	1980	1990	2000	2004	2008
Title Payments for Individuals	65	279	586	1,054	1,383	1,710
Social Security	30	117	246	406	491	587
Medicare	7	34	107	215	279	340
Medicaid	3	14	41	118	183	233

Source: Budget of the United States Government, Historical Tables, Table 11.3

¹ As is customary, these are 10-year totals are derived from the Congressional Budget Officer's baseline methodology and include the debt service costs added by tax cuts.

² When Bush became President, OMB published 10-year projections of budget policy; it now limits these projects to 5 years.

³ I have characterized his father's presidency as failed solely because he did not win reelection. No other assessment is intended.

⁴ Office of Management and Budget, A Blueprint for New Beginnings February 28, 2001, p. 172

⁵ David A. Stockman, The Triumph of Politics, Harper and Row, 1986. The book is subtitled, Why The Reagan Revolution Failed.

⁶ Reagan's tax legislation is chronicled in C. Eugene Steuerle, The Tax Decade, The Urban Institute Press, 1992.

⁷ Ibid., Chapter 11.

⁸ These rules are detailed in Allen Schick, The Federal Budget: Politics, Policy, Process, revised edition, The Brookings Institution, 2000.

⁹ The Budget Enforcement Act (BEA) established district rules for discretionary and mandatory spending. Discretionary spending, defined as spending controlled by annual appropriations was capped. These caps, which expire in 2003, were designed to limit the amount appropriated each year, but (as explained in the text) actual appropriations exceeded the limits in the 1999-2002 years. Mandatory spending was not capped, but it and revenue legislation were subject to PAYGO rules that required any increase in the deficit or reduction in surplus due to new mandatory spending or revenue legislation to the offset.

¹⁰ See Alan T. Peacock and Jack Wiseman, The Growth of Public Expenditures in the United Kingdom, Princeton University Press, 1961.

¹¹ Before baselines came into vogue, spending changes were measured in nominal terms, with the previous year's "base" (rather than a projected baseline) used to calculate the dollar value of changes. Baselines are used to "score" – measure the budgetary impact – of a policy change, and to enforce various budget rules. When the baseline is adjusted for inflation, the score does not include increases due to inflation, thereby making the spending increase smaller than if inflation were excluded.

¹² Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 2004, March 2003.

¹³ Richard Rose and Terrance Karran, Taxation by Political Inertia, Allen & Unwin, 1987, pp. 1-2.

¹⁴ Martha Derthick, Policymaking for Social Security, The Brookings Institution, 1979.

¹⁵ For example, the federal estate tax would be phased out by 2010 but would reappear at 2001 rates in 2011.

¹⁶ Committee for Economic Development, Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America, March 2003.

¹⁷ <http://www.taxfoundation.org>.

¹⁸ Bush proposed refundable tax credits for health insurance and education; he also proposed an expansion of the earned income tax credit. CBO has estimated that these proposals would add \$23 billion to federal outlays during the 2004-2010 period. CBO, op. cit, p. 13.

¹⁹ Economic Report of the President, February 2003, pp. 52-58.

²⁰ Quotes in "with tax bill passed, republicans call for more," The New York Times, May 24, 2003.

²¹ Cited in The New York Times Magazine, April 6, 2003, p. 51.