# The Big Fix: Stimulate, but Watch the Red Ink

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Document date: December 29, 2002
Released online: December 29, 2002

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WASHINGTON — We are witnessing a new twist in the longtime struggle between tax cutters and budget balancers. In an astounding role reversal, many Democrats have donned the hair shirt of fiscal responsibility worn for so many decades by Republicans — who never gained much political advantage from their economic rectitude. Meanwhile, the Republicans have become the good-time party of government largess, offering tax cuts for every occasion.

But to understand the switch, one must understand the reasons behind it. And here it becomes apparent that the parties — and factions within the parties — approach the balance between tax cuts and balanced budgets very differently.

So what are the nuances of today's positions? Both parties have a smattering of traditional conservatives who approach budget questions from a strong belief in reducing the size and scope of government. They think that the best way to limit government spending is to limit revenues: You have to starve the beast in order to control the beast.

There is an element of truth to this theory. Almost certainly, government spending is lower today than it would be if President Reagan had not managed to pass his large tax cuts in 1981. But spending was never brought down to quite the levels hoped for by supporters of Reagan's initial tax cuts, and many of the cuts were whittled away by a series of significant tax increases between 1982 and 1993.

Supply-siders also favor tax cuts. This faction believes tax cuts are the quickest way to promote economic growth — with the most rabid of the breed believing that tax cuts will ultimately increase revenues. Again, there is an element of truth to the theory. Tax burdens can become so oppressive that they stifle economic activity and encourage illegal tax evasion. When some marginal income tax rates exceeded 90%, they may have had such an effect. But we got rid of such absurdly high tax rates long ago, and empirical evidence strongly suggests that across-the-board cuts in today's rates would reduce, not increase, revenues.

Among the budget balancers, the most extreme faction argues that, contrary to conventional wisdom, increased government deficits do not stimulate the economy. Rather, they raise interest rates so much that deficits become contractionary by stifling investment. Like supply-side economics, this theory suffers from a lack of empirical support. It is difficult to find any relationship at all between deficits and interest rates. This does not necessarily mean that no relationship exists. It just means that it is overwhelmed by other, more important factors such as monetary policy and changes in inflation.

Tax cutters often seize on the weak relationship between interest rates and deficits to rationalize increasing the deficit. But deficits negatively affect the economy whether or not they push up interest rates. Deficits tap private savings, leaving less to finance investment. They also increase our reliance on foreign borrowing. Ultimately, deficits reduce national wealth, and that is bound to reduce long-run living standards.

The biggest deficit danger, though, is that the national debt will get completely out of control, increasing faster than our incomes. The interest bill on that debt is also then likely to grow faster than our incomes. It can then become politically impossible to raise taxes and cut spending fast enough to keep up with the rising interest bill, which can cause debt to explode. Governments often print money under these circumstances to avoid issuing more debt. Hyperinflation soon follows.

In the 1980s and early 1990s, there was cause to worry about an exploding debt. Between 1979 and 1993, the debt rose from 26% to 50% of gross domestic product. It was imperative that we do something about the situation, and we abandoned all thought of using deficit increases to stimulate the economy. Taxes were actually raised during the recessions of 1982 and 1990.

It is hard to feel the same sense of urgency about today's deficit. It was $159 billion in 2002. Adjusted for the size of the economy, 1983's deficit would have amounted to more than $600 billion. That does not mean that

today's deficit is desirable; it only means that it is not alarming. Ironically, that makes it harder to make fiscal policy choices. We cannot focus single-mindedly on deficit reduction, which means that every call to increase the deficit must be weighed on its merits.

Passive increases in deficits are generally acceptable when they are the result of wars or recessions. It is very inefficient to respond to every temporary change in the budget by changing tax laws. Moreover, increased deficits can cushion reductions in economic activity associated with recessions.

The question before us at the moment is whether we should be more aggressive and purposely increase the deficit with the goal of ending the sluggishness now afflicting the economy. I do not believe that would be wise. It would be almost impossible to design a package, implement it and have it affect economic behavior before the second half of next year. Almost all economic forecasters see the economy resuming its recovery at a decent pace before then. Of course, forecasts do not typically factor in a war. If war with Iraq were to go badly, and there were a very large and lasting effect on oil prices, some fiscal relief would then be justified.

The administration properly differentiates proposals aimed at increasing jobs from proposals aimed at enhancing long-run economic growth. It is discussing some appealing tax cuts to promote the latter. These include reducing the heavy tax burden on dividends, increasing deductions for capital losses and increasing deductions for retirement saving plans such as IRAs. In many economic models, such tax cuts can enhance economic growth for a time despite their negative effect on the deficit. Unfortunately, the ill effect of the deficit grows as the interest bill on the associated debt grows. Eventually, the positive effects of improved incentives are overwhelmed by the negative effects of the revenue loss.

The answer is clear.

If President Bush wants tax cuts aimed at growth, he should offer them in the context of a credible overall budget plan that shows progress in reducing the budget deficit over time. If the deficit-increasing effects of growth-oriented tax cuts are countered, they will have an unambiguously positive effect. Liberals will protest tax cuts for capitalists, but that argument has never resonated well with voters — and today there are many more capitalists than there used to be.

It will not won't be easy to develop such a plan. Republicans are committed to providing prescription drug coverage under Medicare — the most important spending initiative in decades — and they will be pressured to provide expensive tax cuts to limit the number of citizens drifting under the alternative minimum tax. But a long-term deficit-reduction plan could be managed if discretionary spending, including defense, is treated austerely.

Managing all this will take leadership from Bush. Budgeting must be done with discipline. The president will have to veto some spending measures, which he has not done so far. The compassionate conservative will have to become less compassionate.

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