

**Fiscal Policy: Its Macroeconomics in Perspective**

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# **Fiscal Policy: Its Macroeconomics in Perspective**

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## **Abstract**

President George W. Bush is preparing a drastic permanent reduction in federal income and estate taxes. He cites as precedents tax cuts by Kennedy–Johnson 1962–64 and Reagan 1981. In those cases, however, the economy was operating well below full employment and needed a “demand-side” stimulus (even though Reagan advertised his tax reduction as “supply-side”). In 2001, however, the economy is very close to full employment, and if it needs a stimulus at all, it is a quick modest temporary one instead of the large permanent one proposed. And why can’t monetary policy do the job of stabilization, as it did successfully in the 1990s? A policy mix that assigns short run demand stabilization to the central bank is for several reasons preferable to a tight-money-easy-fiscal mix. In the case of Reagan and Bush the younger, federal tax cuts are advocated on philosophical and ideological grounds, diminution of the size and scope of government. But formulation of the issue as government versus people is a misunderstanding of democracy and of the reciprocities between public and private sectors.

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In making a major cut in federal income taxes the centerpiece of his program, George W. Bush has followed two influential precedents, one of Democratic Presidents Kennedy and Johnson in 1962–64 and the other of course that of Republican President Reagan in 1981. Candidate Bob Dole obeyed Republican tradition by proposing in his 1996 campaign a 15% cross-the-board cut in income tax rates. Instead the reelection of Bill Clinton continued the regime of fiscal discipline and monetary wisdom begun by Treasury Secretary Rubin and Federal Reserve Chairman Greenspan in 1993. The economy and the federal budget were doing so well in election year 2000 that it seemed unlikely that young Mr. Bush could be elected, much less succeed in reviving Reaganomic fiscal policies. Yet now in 2001 it seems quite probable that a substantial permanent cut in income taxes will be enacted, along with an emergency package to encourage spending soon this year.

The story of macroeconomic and fiscal developments over the last forty years is an amalgam of economic theory, politics, and ideology. I admit to being both a Keynesian and a neoclassical economist and both a liberal and a conservative in public policy. I was an adviser to President Kennedy, and an informal consultant to other Democratic candidates. Win or lose, my advice was very often not taken.

### **JFK's Tax Cuts and Their Unhappy Sequel**

In 1962–64, when JFK first considered and then recommended cutting taxes, the economy was hesitantly recovering from the 1959–60 recession. Kennedy's first measures were incentives for business plant and equipment investments, accelerated depreciation allowances and tax credits. The major tax legislation, in 1964, was intended to keep the recovery from petering out prematurely. Unemployment had fallen from 7% at JFK's inauguration in 1961 to the 5–6% range, but the Administration's target was 4%. It was reached in 1965. The stimulus of the tax cut was unexpectedly augmented by spending for Vietnam. The combined spending was excessive, reducing unemployment a point below the 4% target and unleashing unwelcome inflation in 1966–68. President Johnson belatedly and reluctantly was persuaded to prevail on the Congress to raise taxes temporarily in 1968. It was too late, and the Nixon Administration inherited a difficult economy. Moral: unforeseen events may make you regret a permanent loss of federal revenue, and it is awfully difficult ever to raise taxes. This is even truer now that any tax increase is a deadly sin in the litany of the G.O.P.

### **Reagan's 1981 Cut: Supply-side Reform Was Demand Stimulus Instead**

Ronald Reagan's tax cut took effect at the depths of the worst recession since World War II. Unemployment had hit double digits. This was the cost of the crusade of the Federal Reserve under Chairman Paul Volcker against an inflation that itself had in 1979–80 hit double digits. The tax cut was a big stimulus to consumer and business spending, reinforced by Reagan's buildup of the U.S. military.

The period 1981–88 was one of recovery from the recession, bringing unemployment back down to 6%. The high year-to-year rates of increase of economic activity and real Gross Domestic Product (GDP) during such business-cycle upswings reflect the re-employment of idle resources, both workers and industrial capacity. This additional output growth is the essence of prosperity. But

this pace cannot be sustained. Once the economy returns to full employment, the economy can grow only at its long-run sustainable rates of increase in the supplies of economic resources and, especially, in their productivity.

The architects of Reaganomics styled themselves Supply-Siders. They scorned the Demand-Side theories and policies they attributed to John Maynard Keynes and to his “liberal” followers, whom they held responsible for the stagflation of the 1970s. In their view the Federal Reserve could and should control inflation by stabilizing the supply of money, as preached in the Monetarism of Milton Friedman. Keynesians were, they argued, dangerously wrong to think that Demand-side stimuli to spending could lift employment, GDP, and economic welfare. Instead what the country needs are policies to enhance Supply, in particular by lower taxes, providing incentives to work, save, innovate, take risks. That was the spirit and the purpose of Reagan fiscal policy.

In practice Reaganomics turned out to be the biggest and most successful Demand-side fiscal gambit in peacetime U.S. history. What it was not was what it was intended to be, a Supply-side transformation of the economy. There was zero evidence that the American economy’s capacity to produce goods and services *at full employment* was any greater at the end of the ‘eighties than would have been prophesied a decade earlier without Reagan fiscal policy. The trend of productivity growth was the same as before.

These Supply-side failures may seem surprising, since income tax cuts were meant to embody incentives for more productive and innovative behavior. Unfortunately these cuts in tax rates also bring windfalls for behavior that already took place. For example, offering concessions for capital gains on future acquisitions of assets might be socially useful, while reducing taxes on gains realized on holdings bought years ago clearly is not. The test is whether the taxpayer must in order to benefit change his behavior in the desired supply-side direction. If yes, the touted incentives work. If no, the individual taxpayers’ gains have to be defended otherwise, as deserved and just. Undergraduate microeconomics students know the difference between the “income effects” and “substitution effects” of variations in prices or taxes. The substitution effects are responses to incentives, but they are often outweighed by income effects in the perverse direction. Income effects may sometimes be what the doctor ordered, more consumer spending. But those effects can overwhelm Supply-side objectives. A cut in marginal income tax rates may elicit more work from some taxpayers, but workers whose taxes are reduced anyway may take some of their gains in leisure. The same objections apply to tax credits intended to induce desirable behavior, for example saving or paying

school and college tuitions. These devices have long been favorites of politicians in both parties. The trouble is that they are often windfalls for persons who would behave in the desired way without any subsidies, who are already saving or paying tuitions. The government loses revenue or other taxpayers pay more or other programs are curtailed. Yet the intended objectives are not achieved. Individual Retirement Accounts (IRAs) are a flagrant example. The investing taxpayer acquires tax-free accounts, not by saving more, the *raison d'être* of the program, but just by cashing in other assets or borrowing. Despite repeated giveaways subsidies of this kind, the United States remains a very low-saving country.

### **The Macro Policy Mix: Did Greenspan Make Fiscal Policy Obsolete?**

Prosperity per worker was greater in 1989 than in 1981 not because of a Supply-side revolution but because of Demand-side stimulus. That is, consumers and businesses and governments were spending more and putting to work previously idle workers and plants. The Reagan fiscal policy certainly helped bring about those happy results. Was it necessary?

Not according to modern mainstream macroeconomics, which would say that Federal Reserve monetary policy could have done the job on its own. Indeed Fed Chairman Paul Volcker, who after all was the author of the 1978–82 recessions, decided in 1982 that he had won the war against inflation and pressed the lower-interest button for recovery. Both fiscal and monetary policies are Demand-side instruments (not to say that they might not also have Supply-side effects). The two instruments are in various possible degrees alternatives to one another in federal government policy to control aggregate Demand. Choosing the mix of the two instruments is a most important policy decision for President, Congress, and Federal Reserve. Different mixes can have equivalent effects on spending and Demand and thus on business-cycle developments, and yet differ significantly in other important respects.

In the 1980s President Reagan and Congress ran an easy fiscal policy and forced Volcker's Fed to keep the recovery from overheating by following a tighter, higher-interest monetary policy than usual in previous business-cycle recoveries. Contrast the Clinton-Greenspan policy mix of 1993–2000, tight budget and easy money. The Reagan–Volcker policy mix tilts the composition of national output to consumption by citizens favored by tax concessions and to national defense and other increased government programs, away from business and public investments deterred by high interest rates and scarce loan finance. The 1990s economy with the Clinton-Greenspan policy mix

was, in most reckonings, much the happier time.

Sometimes a low-interest monetary policy is infeasible. The burden of Demand-side measures to achieve or maintain full employment then falls on fiscal measures, and among those often on tax relief. In the early 1960s the Federal Reserve and the Treasury felt that defense of the gold standard value of the dollar forced them to keep U.S. interest rates competitive with those in Europe and Japan, compelling greater reliance on tax cuts in the mix of policies for domestic prosperity than would otherwise have been desired. In the U.S. in the Great Depression of the 1930s and in Japan in the 1990s monetary policy became virtually impossible because interest rates were as low as they could go, zero on safe short-term paper. This predicament was known to economists as Keynes's "liquidity trap," from which fiscal stimulus was the only way out.

Governments and legislators often feel that their central banks are keeping interest rates too high, monetary policy too tight. In 1991–92 President George H.W. Bush thought that Alan Greenspan's Fed was unduly cautious in stimulating recovery from recession. The Bush camp blamed the sluggish economy for its defeat in the 1992 election. At the same time, fiscal initiative was limited because the Democrats, controlling the Congress, were tired of Reaganomic budget deficits and indeed forced President Bush *per se* to sign a budget containing a small tax increase. This episode is probably one reason that President Bush *filis* is stressing fiscal policy to pep up his "sputtering" economy in 2001. Maybe it is also one reason why Alan Greenspan has spoken favorably of George W. Bush's proposed tax cut.

In 1992-93 a number of economists of both political persuasions agreed, both before and after the 1992 election, that the economy needed temporary fiscal stimulus. Two former Kennedy advisers, Professors Solow and Tobin, argued this case at a transition economic policy discussion with President-elect Clinton at Little Rock. But on the insistent advice of his new Treasury Secretary, Robert Rubin, President Clinton and his Democratic Congress rejected this proposal in favor of immediate tight fiscal discipline. Greenspan and his Fed then followed a monetary policy easy enough to offset the negative Demand-side effects of the tight budget. Sometimes Clinton, Gore, and Rubin seemed to attribute the great prosperity and growth of the 'nineties entirely to their fiscal policy. But Greenspan was their indispensable ally. The tight-budget-easy-money mix was the key. The danger now in 2001 is that the new Republican president will return government and economy to the bad old policy mix of Reaganomics.

## **Sixty Billion Stimulus Now And/or Two Trillion over a Decade?**

When George W. Bush made a repeat of Reagan's income tax cut the central economic and fiscal issue of his campaign for president, he was not taken very seriously. The general public was not much interested. The economy was doing splendidly without it. Social Security and Medicare seemed higher priority uses of prospective budget surpluses. Even among Republicans only right-wing Supply-Siders chronically inimical to government seemed enthusiastic for big tax reductions.

Mr. Bush, it turned out, meant every word of it and every number too. He was prepared to use any argument and any stratagem to get his proposal passed. The slowdown in the economy in 2001 provided, he thought, a great opportunity. He could now claim that his tax cut is needed to prevent or limit a recession. At the beginning of the year mainstream macro economists poo-hooped this idea as outdated vulgar Keynesianism — hasn't Alan Greenspan taught us all that monetary policy, a much more efficient and flexible instrument, without such lasting costs and risks, can do the job? But bad news from stock markets convinced economists, business leaders, financiers, labor leaders, and Congressional Democrats that some fiscal stimulus is essential to save the economy. Greenspan, Volcker, and Rubin, heroes of fiscal discipline and monetary policy in the 1990s now endorsed some fiscal initiative.

The bad news for the President is the increasing realization that his ten-year back-loaded income tax cut is not the answer to the immediate ills of the economy. Its demand-side stimulus, even if made to take effect as of the beginning of 2001, is too long delayed and goes to the wrong people. What is needed is a one-shot dose of cash, directed to consumers most likely to spend it. The Ford Administration put \$8 billion out in April–June 1975, a 10% rebate of 1974 income tax up to \$200 per household. This was small but successful as far as it went. The design could be improved. Cash should be directed to consumers most likely to spend it promptly, the poor and the cash-poor, those whose spending is constrained by illiquidity. Many Americans who need help and would surely spend are not on income tax rolls. The whole population should be covered, not just income taxpayers.

A fiscal lifesaver of this kind would receive wide bipartisan support while leaving the permanent shape of the income tax up for more deliberate decision. The president likes the “jump-start” metaphor, which ill fits his own proposal but possibly describes Senator Domenici's \$60 billion injection of disposable income this year, like the economists' 1992–93 proposal that didn't happen.

Perhaps the time has also come to revive consideration of a Kennedy–Johnson proposal from the 1960s. This is to enact legislation putting on the shelf a plan for temporarily cutting or rebating taxes or otherwise distributing spendable cash. The President might be empowered to put it into effect on a finding of economic need, or just to recommend it for expedited consideration by Congress. The point is to avoid the delay for debate and detail that can make fiscal policy a cumbersome instrument of business cycle stabilization.

### **Of the People, by the People, for the People!**

Like Reagan fiscal policy, that of the new Republican administration seems more a political and ideological attack on government than an economic reform. The overriding objective is once again to shrink radically the share and role of government — especially federal government — in the economic and social life of the nation. President Reagan described tax revenues as the “children’s allowances” of Congress. Reduce taxes, and Congress will have to spend less. In the period 1981–1993 this strategy utterly failed. Democrats controlled the Congress. They fought a stalemate with the Executive over whose programs would absorb the losses of revenues. Some tax cuts were reversed or offset, but mainly budgets moved heavily into deficit, the largest increases in federal debt (in dollars and relative to the economy) in peacetime history. At the same time, many meritorious public investments and social programs were crowded out by military buildups and tax cuts.

President George W. Bush has resumed the crusade against government. “The federal surplus is not the government’s money. It’s the people’s money and should be returned to the people. If it lies on the table, Congress will spend it.” Bush makes it sound as if we were ruled by an alien tyrant or a divinely ordained monarch. Is it not the people’s government, of the people, by the people, for the people? It’s American people who pay the taxes. It’s American people who receive outlays in cash or kind and who benefit from public services. The federal debt is the people’s debt, most of it owed by the people to the people. We the people also have solemn but unfunded obligations to future dependents on Social Security and Medicare. Two years ago both political parties solemnly put the Social Security Trust Fund in a “lock box” Clinton and Gore went farther, proposing to beef up the Social Security Trust Fund with part of the surplus elsewhere in the budget. President Bush is emptying the lock box, counting it and the Medicare fund in his general contingency reserve. Moreover, he himself has recognized a host of other national priorities — education, science and technology, environmental protection, health insurance, prescriptions, energy,



poverty. He seems not to be budgeting for them, but all of them might well be more important than adding to the personal consumption of affluent Americans. The way the country has been prospering and growing, it is hard to complain that federal taxes are impoverishing us, or even that they were doing so when they were much higher in past decades.

The surplus is the taxpayers' own money? The idea that the high incomes of wealthy Americans are due solely to personal qualities superior to those of other eras and other lands is arrogant and ridiculous. We're lucky to be Americans and to have benefitted from a civilization to which our democratic government is an essential contributor.