BUDGET Myths

Six myths about the Reagan/Bush budgets (and a lesson for Bill Clinton)

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Illustrated by David Povilaitis

Passage of President Clinton's reconciliation package has set the stage for another act in Washington's long-running drama about fiscal policy. Because budget policy is impenetrable to most, shrouded in arcane terminology and mind-numbing detail, success or failure is defined by prevailing mythologies. Dispelling the myths is important, not only for the sake of historical accuracy, but also to help a new administration devise a long-term budget strategy. Understanding what happened in the Reagan/Bush years and the first Clinton budget can teach a vital and heretofore overlooked lesson about how to—or not to—get control of the federal budget.

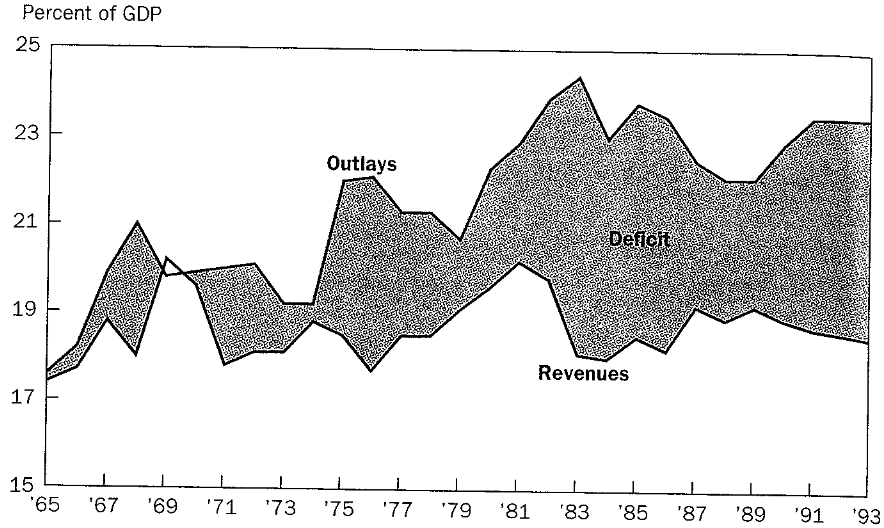
Myth 1: *The Reagan tax cuts created the current mess.* Reagan came into office pledged to lower taxes, and he did. But the reductions were not so deep as most people believe, and, in any case, they were substantially reversed before he left office.

Federal tax revenues for most of the post-World War II period have been remarkably stable. Between 1970 and 1978 revenues hovered just over 18 percent of Gross Domestic Product (GDP). Then they started to rise sharply, fed in part by the bracket creep that resulted from the failure to index tax rates at a time of high inflation. By 1981, they had reached 20.2 percent, the highest they had ever been in our history, and they seemed destined to continue rising (see Figure 1). [Unless otherwise indicated, dollar figures in this article are in constant, inflation-adjusted 1992 dollars. Many of the comparisons are made as percents of GDP because they better illuminate the relative priorities among programs and the relationship of total outlays and revenues to the economy. But using GDP as the base measure does create distortions. In a recession, the taxable portion of GDP declines faster than GDP as a whole; during a recovery, the opposite is true.]

Anger over taxes undoubtedly contributed to Reagan's 1980 election. Once in office, he proposed major tax cuts, which set off a bidding war, with congressional Democrats and Republicans vying to show who could reduce taxes more. By 1983, the resulting cuts, in combination with the recession, had lowered revenues to 18.1 percent of GDP.

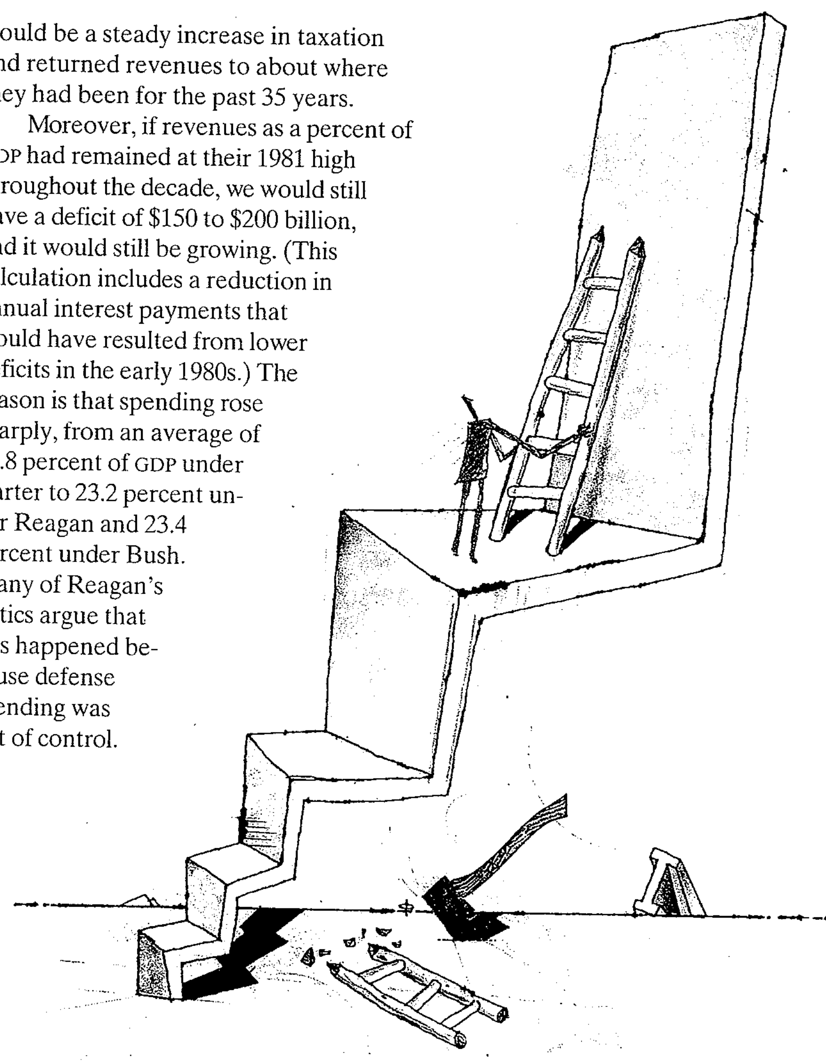
Proponents of the Reagan cuts claim that they fueled the economic expansion of the 1980s. Others disagree. Either way, the cuts were not large enough to account for the deficit's size. Moreover, these initial cuts were followed by 10 major tax increases during Reagan's presidency. As a result of these increases and the improving economy, by 1984–1985, revenues, although still lower than in 1981, were roughly where they had been during the entire post-World War II period. Thus, Reagan merely arrested what appeared would be a steady increase in taxation and returned revenues to about where they had been for the past 35 years.

FIGURE 1
FEDERAL REVENUES AND OUTLAYS



Source: Congressional Budget Office, "Economic and Budget Outlook: Fiscal Years 1994–1998," table E-3.

Moreover, if revenues as a percent of GDP had remained at their 1981 high throughout the decade, we would still have a deficit of $150 to $200 billion, and it would still be growing. (This calculation includes a reduction in annual interest payments that would have resulted from lower deficits in the early 1980s.) The reason is that spending rose sharply, from an average of 21.8 percent of GDP under Carter to 23.2 percent under Reagan and 23.4 percent under Bush. Many of Reagan's critics argue that this happened because defense spending was out of control.



Myth 2: *Reagan's defense buildup caused the deficit to explode.* Reagan did preside over an increase in defense spending, but it was neither as large nor as sudden as most people suppose. Even in its peak years, new defense spending under Reagan averaged only 8 percent of each year's total deficit.

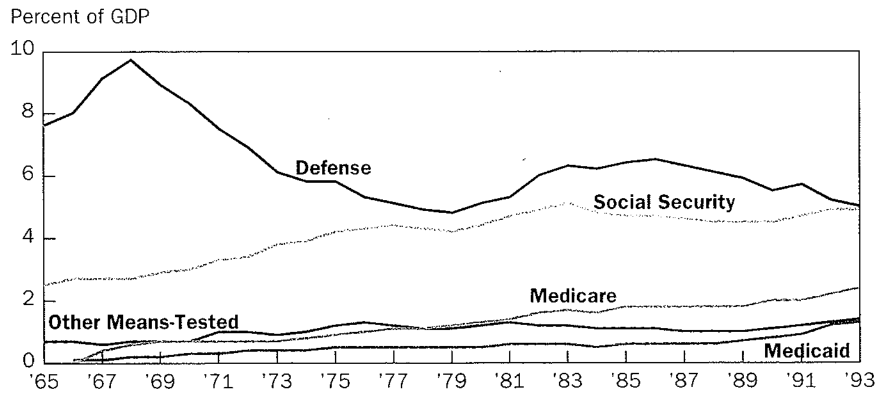
Defense spending as a percent of GDP began to increase in 1979, as President Carter responded to increased Soviet activity around the globe. The Carter defense budgets of 1980 and 1981 posted increases of 6 percent and 4 percent, respectively, over the previous years. Reagan increased the rate of expansion to 13 percent in 1982, but, by the following year, the pace of expansion had slackened to Carter-era levels (5 percent). In the ensuing three years (1984–1986), the rate of expansion fluctuated from -1 to 3 to 1.5 percent, respectively. So only in 1982 did Reagan expand defense spending faster than Carter had in his last two years in office.

Defense spending peaked in 1986, at 6.5 percent of GDP, having increased by 22.6 percent between 1981 and 1986. Today it is 4.7 percent of GDP, about where it stood before Carter began his military build-up. It is roughly the same percentage of GDP as Social Security (see Figure 2).

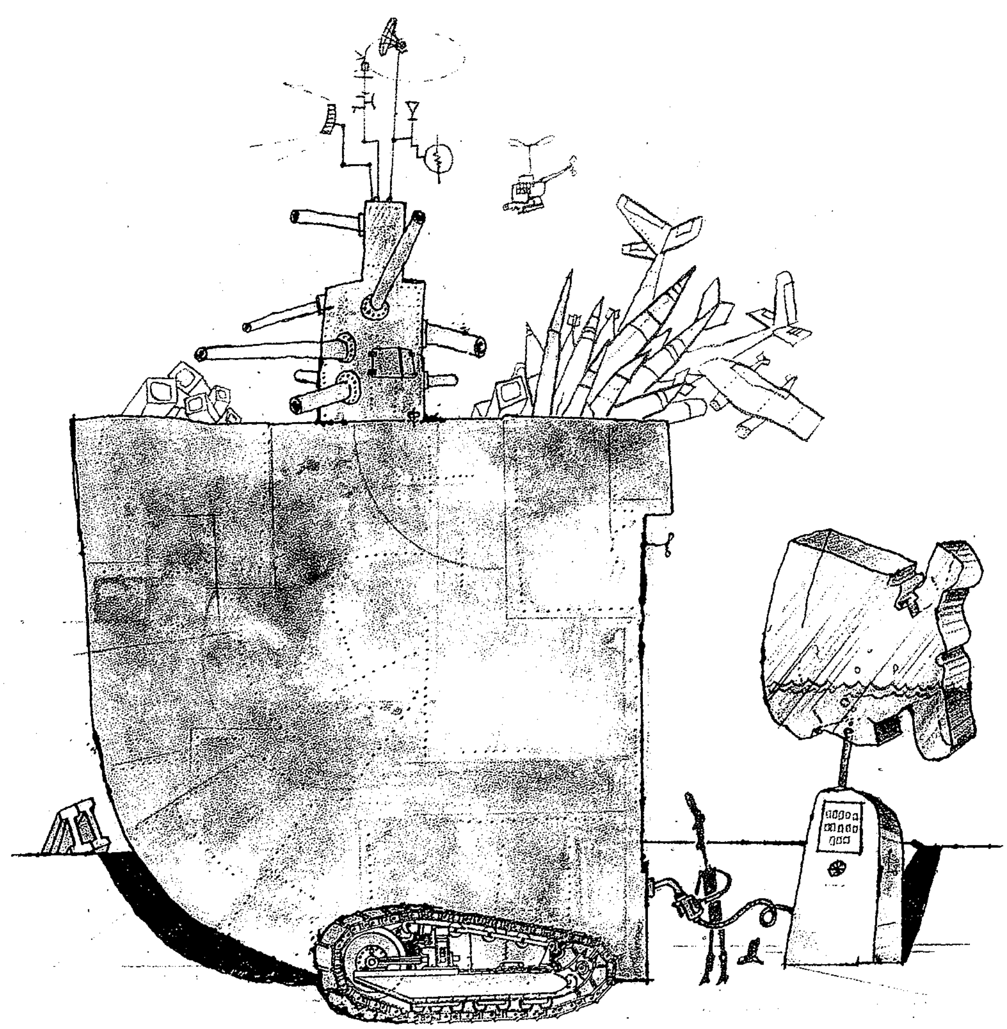
Moreover, despite impressions formed about defense spending at the dawning of the Cold War when it reached 70 percent of total federal outlays, defense spending no longer dominates the federal budget. Today at 19.6 percent of expenditures, it is lower than its 1980 level (22.7 percent). Social Security is now 21 percent of spending; Medicare and Medicaid, 16 percent; and Income Security programs such as food stamps or cash assistance, 14 percent.

Today total defense spending is actually less than the deficit. So even if we totally dismantled our military establishment, we would still have a deficit—and it would still be growing. The real reason for increasing deficits is the growth of other spending, mainly on what appears in the budget as "Human Resources."

FIGURE 2
DOMESTIC SPENDING



Source: Congressional Budget Office, "Economic and Budget Outlook: Fiscal Years 1994–1998," tables E-9 and E-11.



Myth 3: *Ronald Reagan created a gaping social deficit of unmet human needs.* Reagan was no friend of social spending. And enough very visible domestic programs were slashed or terminated in the Reagan years, such as the Comprehensive Education and Training Act (CETA), a \$3.4 billion education and training program in 1981 (\$5.3 billion in 1992 dollars), comes to mind—it is easy to think there were wholesale cuts in social welfare programs. But the cuts were not nearly large enough to affect the social fabric, even of our most disadvantaged communities.

Total domestic spending (excluding interest payments) fell from 16.1 percent of GDP in 1981 to 13.5 percent in 1989. Both mandatory spending (largely entitlements such as Social Security and Medicare) and discretionary spending declined, 11.3 and 28 percent, respectively. Moreover, overall social welfare spending and means-tested programs targeted to the poor also shrank relative to GDP.

The federal budget is divided into five "superfunctions": Defense, Human Resources, Physical Resources, Net Interest, and, of course, Other (see Figure 3). Human Resources includes Social Security, Medicare, Medicaid and other health programs, Income Security programs, and Education, Training, Employment, and Social Services (ETESS) programs; it declined from 12.2 percent of GDP in 1981 to 11.0 in 1989.

Some programs in the Human Resources function for the disadvantaged saw large declines: Income Security [which includes food stamps, Aid to Families with Dependent Children (AFDC), the Women, Infants, and Children Supplemental Feeding Program (WIC), the Earned Income Tax Credit (EITC), and unemployment compensation] and ETESS, for example, fell 24 percent and 36 percent, respectively. But Human Resources also includes many large, middle-class entitlements, such as Social Security and Medicare,which rose continuously during the 1980s.

Clearly, when measured against GDP, social spending was down. If one thinks

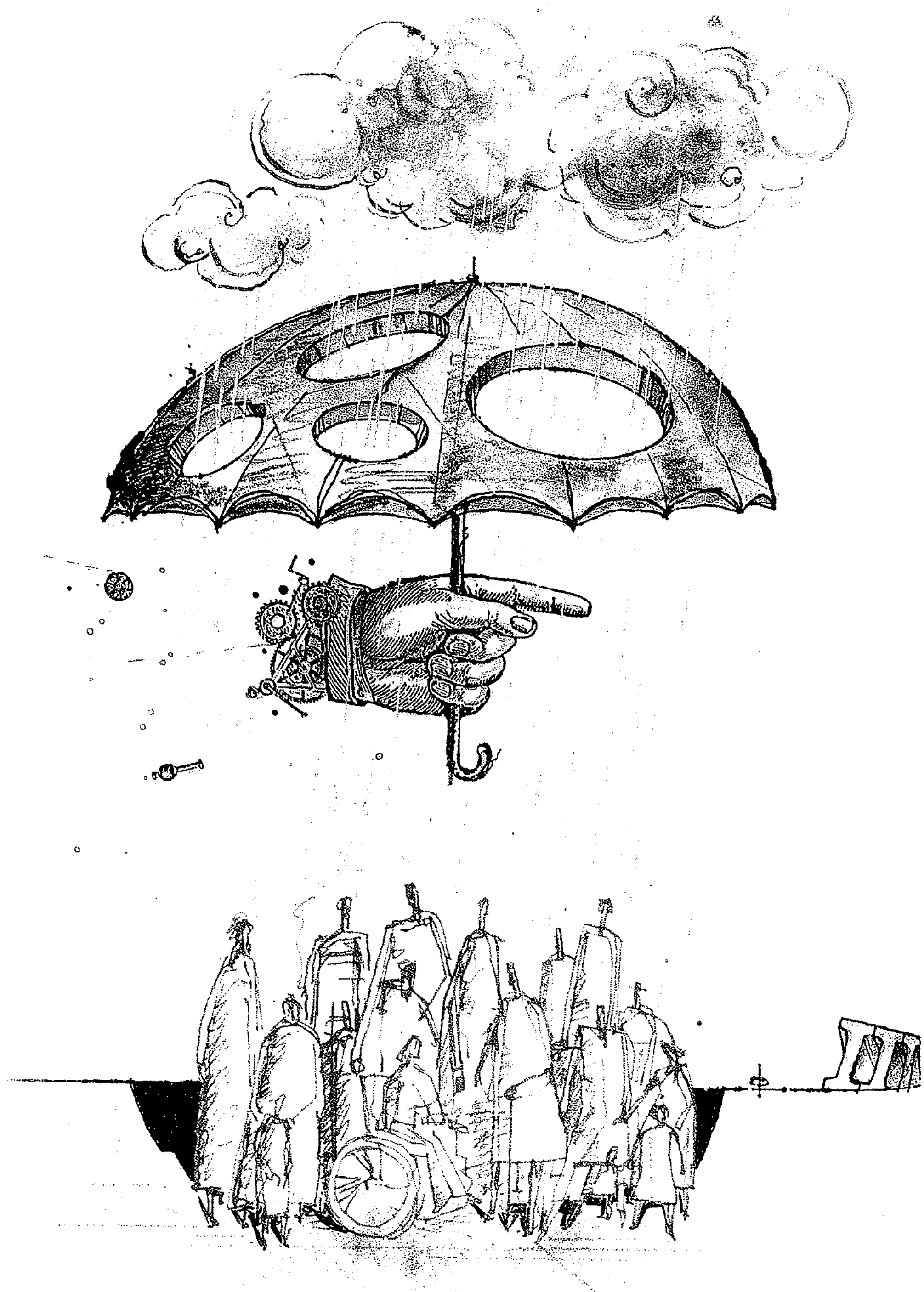
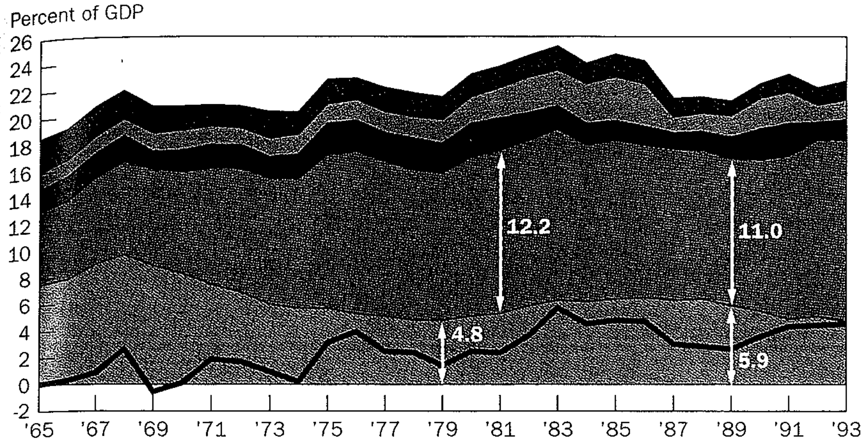


FIGURE 3
FEDERAL EXPENDITURES BY CATEGORY



Source: Office of Management and Budget, "Budget Baselines, Historical Data, and Alternatives for the Future," table 3.1.

of this as a valid way of gauging relative priorities, then one must conclude that—starting in the final Carter years and continuing through the Reagan years—priorities shifted away from social spending and toward defense at first and deficit control later.

It is not so much that total spending was cut as that it did not grow as fast as the economy. In terms of constant dollars, total domestic spending increased from 1981 to 1989 by 6 percent, or $41 billion, with mandatory (largely entitlement) spending up 12 percent and discretionary spending up 10 percent. Similarly, spending on Human Resources increased 13 percent, or $72 billion.

Even measured in constant dollars, however, there were relative "winners" and "losers." The biggest "winners," again, were Medicare and Medicaid, which posted the largest increases at 56 percent and 32 percent, respectively, and Social Security, which rose 19 percent. The "losers" included Income Security programs, which declined 2 percent, and educational training programs, which were slashed by 21 percent. With the exception of some education and training programs (CETA, for example), the losers did not see real cuts—just the absence of increases above inflation (see Table 1).

While there are many things to criticize about the spending decisions in the Reagan years, they hardly amounted to the current yawning social deficit. If there is one, it is not the result of Reagan-era budget cuts, but rather of a deterioration of social and family conditions.

TABLE 1
HUMAN RESOURCES PROGRAMS
(BILLIONS OF CONSTANT 1992 DOLLARS)

Program	1981	1989	Change
ETESS	52	41	–11
Income Security	155	152	–3
Social Security	217	260	+43
Health	42	54	+12
Medicare	61	95	+34

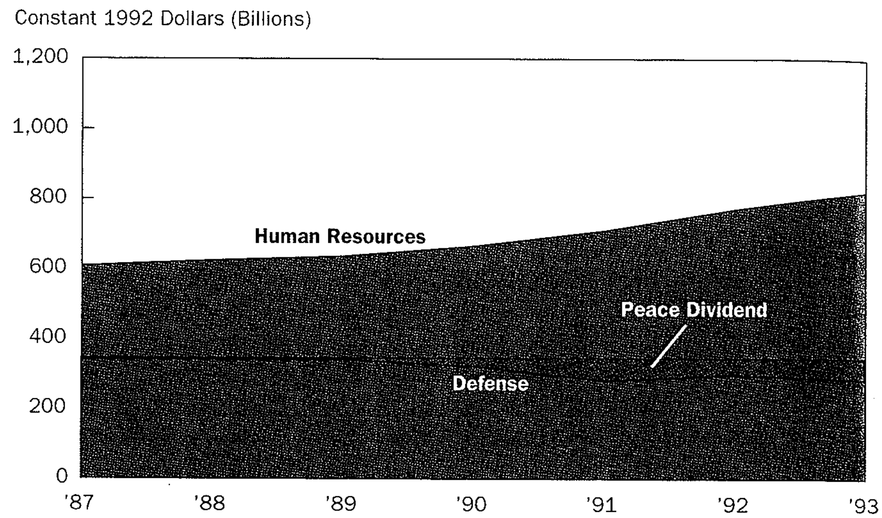
Source: Gene Falk, Dawn Nuschler, and Richard Rimkunas, "1994 Budget Perspectives: Federal Spending for Social Welfare Programs," Congressional Research Service, May 3, 1993.

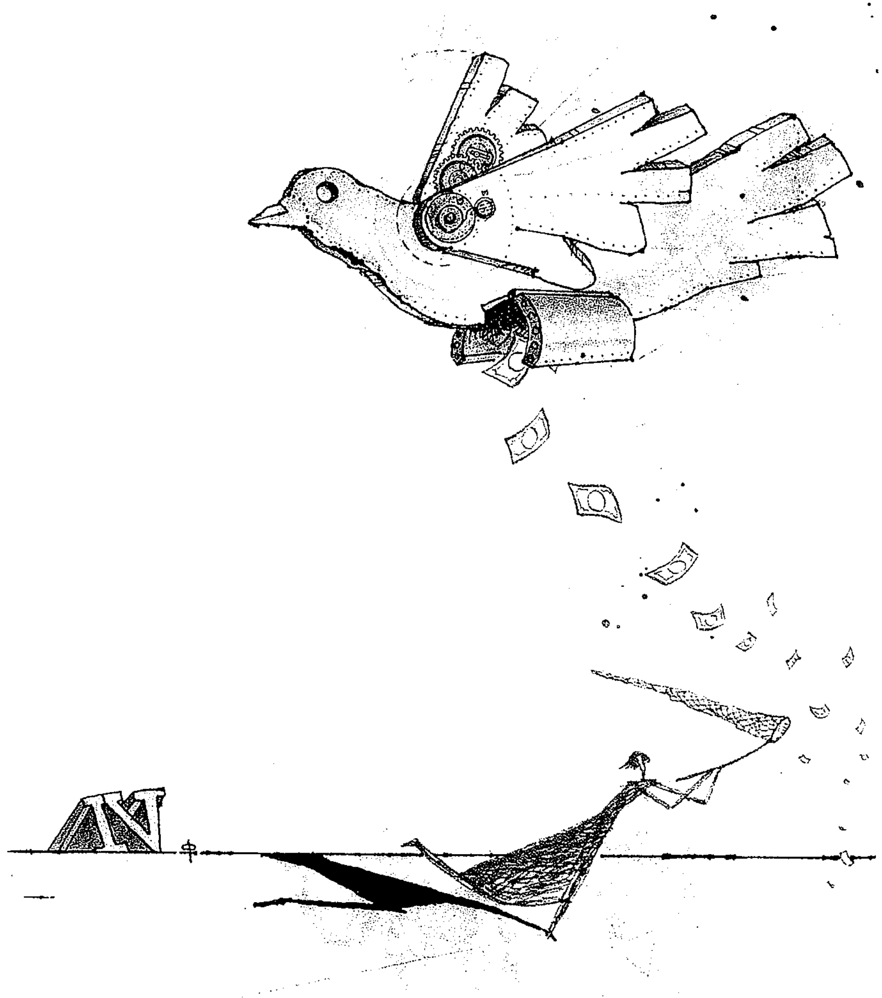
Myth 4: *The peace dividend could pay for increased social spending.* Unfortunately, the money saved by past and projected defense cuts is already being used to help pay for programs previously authorized by Congress.

As described earlier, defense spending as a percent of GDP began declining in 1986. Since then, $188 billion has been freed up—but these savings have been more than matched by increased spending on Human Resources, not to mention other domestic programs (see Figure 4). Between 1990 and 1992, for example, defense spending as a percentage of GDP fell from 5.5 percent to 5.2 percent. (The two-year period was chosen to avoid the temporary increase in spending in 1991 due to the Gulf War.) At the same time, Human Resources spending grew from 11.2 percent to 13.3 percent. In constant dollars, defense spending fell from $321 billion to $298 billion and Human Resources grew from $665 billion to $772 billion.

The Clinton budget for 1993–1998 reduces defense spending by 15 percent—not nearly enough to cover the increase in Human Resources spending slated for that period, let alone reduce the deficit.

Even if the cuts were deeper—unlikely given the international situation and domestic politics—there is simply not enough money in the defense budget to pay for the projected growth of social spending. Over the past four years, Human Resources spending has averaged annual dollar increases that are four times larger than annual dollar defense cuts—and many other domestic programs must still be funded.





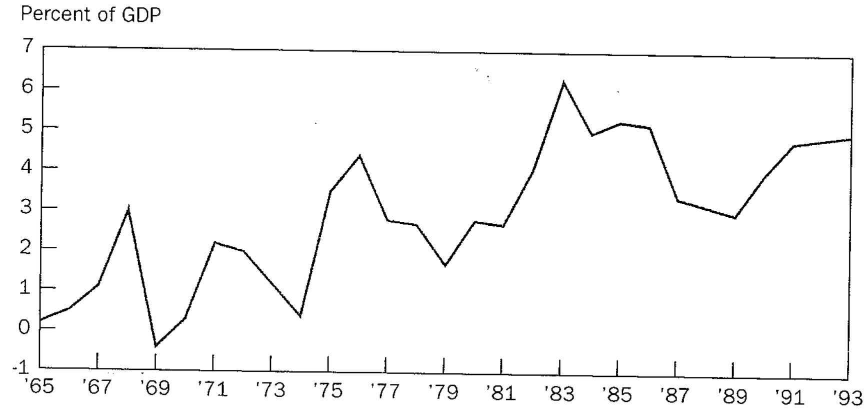
Myth 5: *Clinton's budget is the first serious attempt to control the deficit in 12 years.* Five major deficit-reduction efforts were made during the Reagan/Bush years: TEFRA in 1982, which raised taxes by $214 billion between 1983 and 1987; DEFRA in 1984, which raised taxes another $103 billion between 1984 and 1987; Gramm-Rudman-Hollings I and II in 1985 and 1987, which set spending limits; and, of course, the infamous 1990 Budget Agreement, which tried to do both. Some of these attempts worked better than others, but they were all serious.

In 1989, the deficit—which had risen to 6.3 percent of GDP in 1983—was 3 percent of GDP, about where it was when Reagan became president. (Many, however, argue that the magnitude of the deficit is underestimated because it includes the Social Security surplus. If the surplus is excluded from this calculation, the 1989 deficit would have been 25 percent higher, but still shrinking.) The deficit began to grow again after Bush took office—to 4 percent in 1990 and 4.9 percent in 1992 (see Figure 5). This increase actually began before the 1990–1991 recession, and even before the spending increases contained in the 1990 Budget Agreement took effect. What happened?

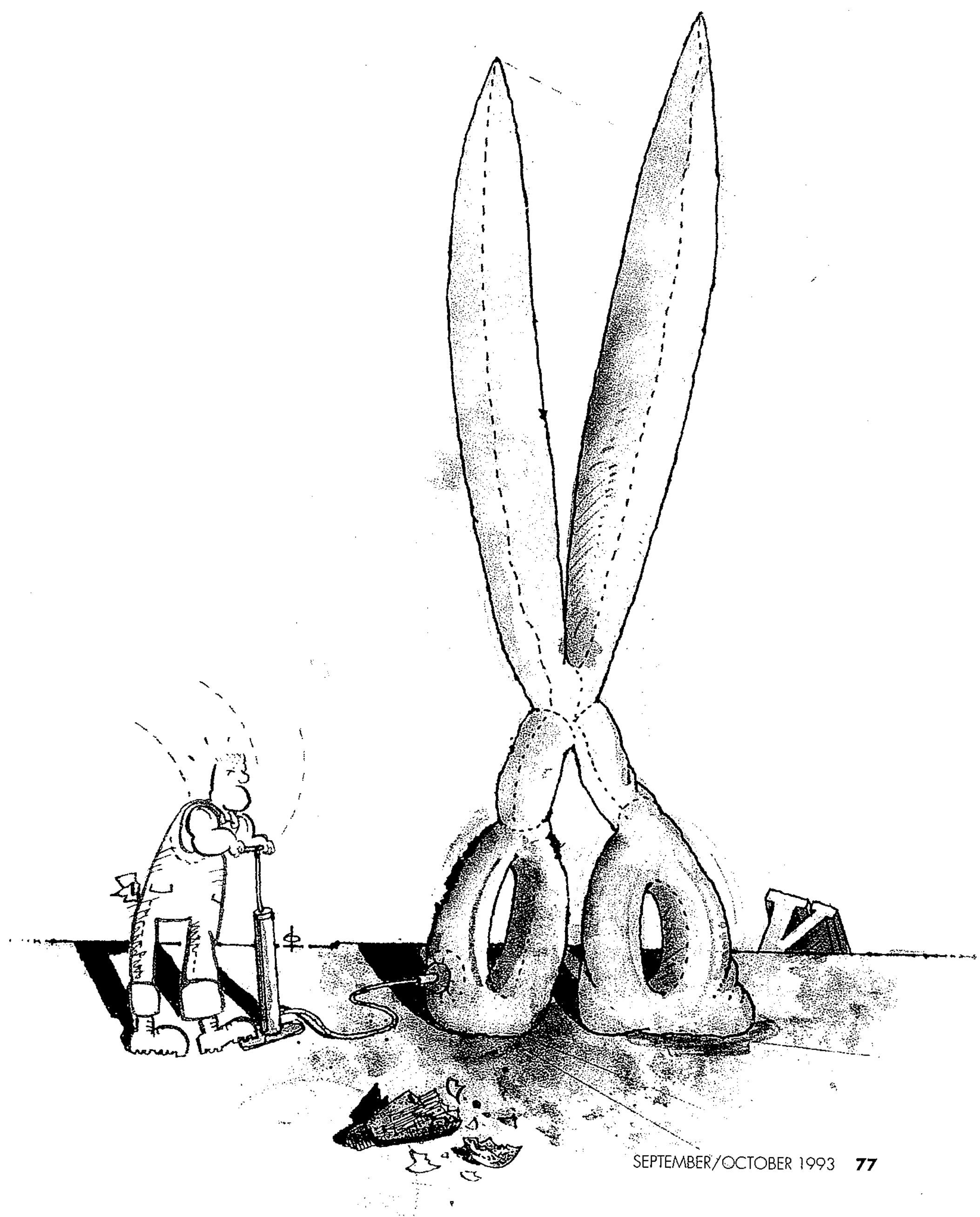
The deficit's decline between 1983 and 1989 is attributable to a strong economy, shrinking defense expenditures, and better control over social spending. On this last point, Gramm-Rudman-Hollings helped. A study published in the *Journal of Policy Analysis and Management* estimates that, between 1986 and 1989, Gramm-Rudman-Hollings "restrained outlays by $59 billion."

The deficit's renewed growth after 1989, on the other hand, was due partly to the weak economy, which depressed revenues, and to increased income security expenditures. The size and persistence of the deficit, however, have a different cause: the Bush administration lost control over domestic spending.

FIGURE 5
THE DEFICIT



Source: Office of Management and Budget, "Budget Baselines, Historical Data, and Alternatives for the Future," table 3.1.



Myth 6: *George Bush merely continued Ronald Reagan's domestic policies.* A veritable explosion of domestic spending occurred under Bush. In Reagan's last five budgets, total federal outlays as a percent of GDP fell from 23.8 percent of GDP to 22.1 percent, a drop of 7 percent. Under Bush, they rose to 23.9 percent by 1993. This increase in outlays is more than twice the 3 percent drop in revenues during the same period, making it the predominant cause of the deficit.

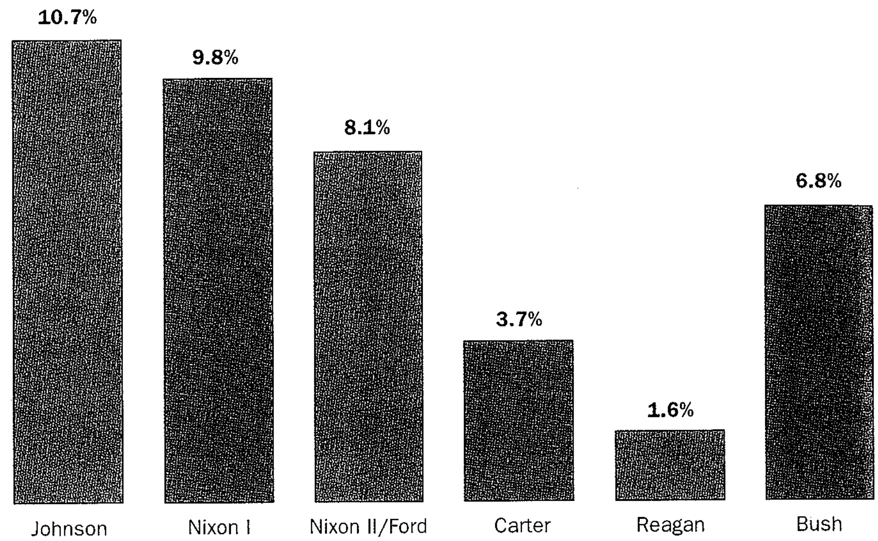
The growth came from across-the-board increases in domestic spending. Both Carter and Reagan slowed the growth of domestic spending. Bush, however, presided over a rising rate of spending increases in both entitlements and discretionary programs. (Contrary to common belief, the savings and loan bailout is only a small part of this increase. Between 1989 and 1992, average annual spending for it was $38.2 billion, or about 16 percent of the deficit.)

In constant dollars, the average annual rate of increase for Human Resources spending under Bush was four times what it was under Reagan, almost twice what it was under Carter, and only a third lower than under Johnson and Nixon (see Figure 6). This is all the more remarkable because the base, that is, the total amount of Human Resource spending, was so much larger in the Bush years. By the time Bush left office, annual spending for both mandatory and discretionary domestic programs had increased $210 billion. This increase alone is two-thirds of the current (1993) deficit.

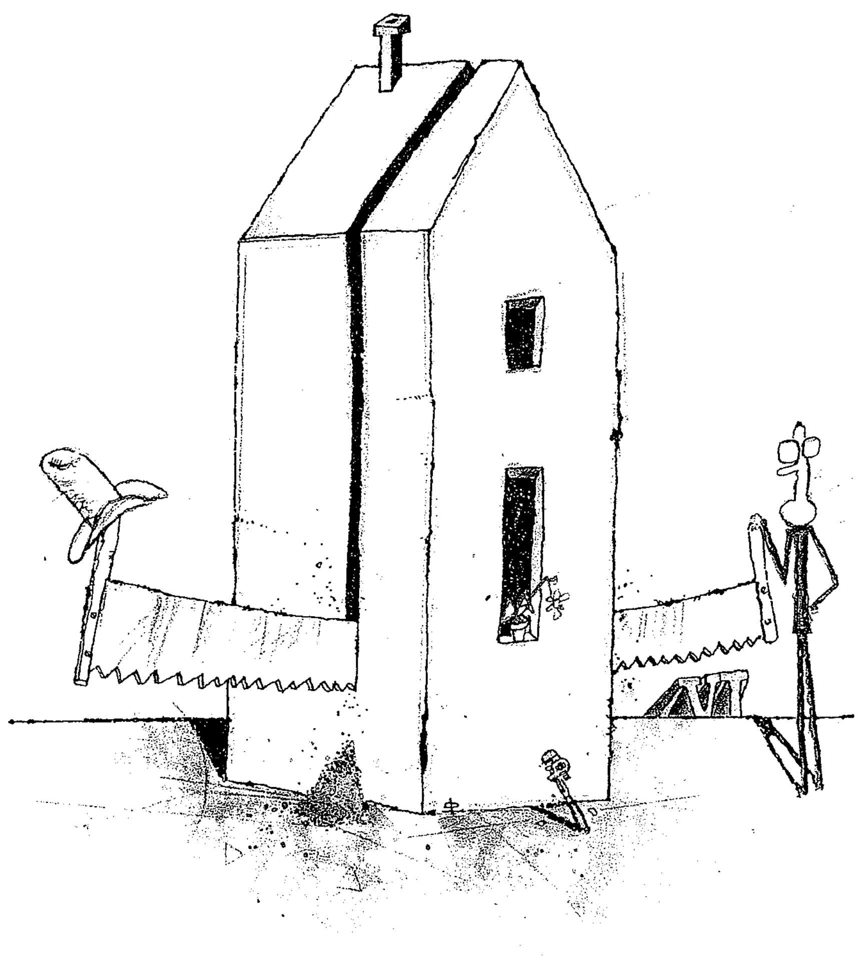
In four Bush budgets, Human Resources spending rose $184 billion. As a percent of GDP, it increased by a quarter. Moreover, each subcategory of Human Resources posted large increases: Social Security grew 15 percent, from $260 billion to $298 billion; Health (95 percent of which is Medicaid spending) grew an astounding 89 percent, from $54 billion to $102 billion; Medicare grew 36 percent, from $95 billion to $129 billion; and Income Security programs grew 34 percent, from $152 billion to $204 billion. Discre-

FIGURE 6

AVERAGE ANNUAL INCREASE IN HUMAN RESOURCES SPENDING



Source: Gene Falk, Dawn Nuschler, and Richard Rimkunas, "1994 Budget Perspectives: Federal Spending for Social Welfare Programs Congressional Research Service, May 1993.



tionary spending was also up: ETESS grew 27 percent, from $41 billion to $52 billion.

A major factor behind these increases, of course, was the weak economy and changing demographics. Higher unemployment and low wages, for example, lead to higher expenditures for such programs as unemployment insurance, AFDC, Medicaid, and food stamps. Similarly, the growth in the aging population explains some of the increases in Medicare and Medicaid. And rising out-of-wedlock birth rates create greater dependency on Income Security programs in general. These uncontrollable expenditures, however, do not tell the whole story.

Take Medicaid, for example. From 1990 to 1991, it grew 30 percent. Urban Institute researchers estimate that as much as a third of this increase was due to a combination of legislated expansions of program eligibility or benefits (particularly among pregnant women and children) and state abuses of reimbursement rules through loopholes that Congress has been unable or unwilling to close.

People can argue about whether this new spending was needed. Either way, the point is that spending rose—at the fastest pace since the Nixon years.

The Lesson for Clinton

Acts of Congress, not acts of God, added tens of billions of dollars to the Bush deficits. Some of these billions went to fund programs that were first advocated by Bush, but subsequently expanded far beyond his original proposal by Congress. For example, in 1989, the president proposed a child-care tax credit similar to the EITC, the five-year cost of which would have been under $15 billion. By the time Congress had finished with it, the EITC's five-year price tag had risen to over $40 billion.

Other spending increases were initiated by Congress, often as seemingly inexpensive riders to a larger bill. Many expansions of Medicaid were accomplished in this manner. The mandate that states expand coverage for low-income pregnant women, their young children, the elderly, and the mentally retarded, for example, was added to the massive 1990 Omnibus Budget Reconciliation Act.

This process was repeated many times. The 1990 Budget Agreement further aggravated the situation. To gain congressional support, it front-loaded large increases in discretionary spending in return for later caps on discretionary expenditures. Whether or not the caps will hold (at this writing, President Clinton has signaled his interest in extending them) the agreement's immediate effect was indisputable: more spending at a time when the deficit was growing.

Among the many attempts to explain why spending grew out of control under George Bush, one factor stands out. He did not use his ultimate weapon to curb congressional spending: the presidential veto.

Bush was not shy about vetoing legislation he did not like. He vetoed 46 bills, and only one, which reregulated cable TV, was overridden. Surprisingly, though, he never vetoed a spending bill for the purpose of lowering expenditures. (While he did veto an expensive unemployment compensation bill, the reason he gave was that Congress had not financed it but had merely added its cost to the deficit.) Although the Congress tended to adhere to the spending caps imposed by the 1990 Budget Agreement, thus making vetoes less necessary after its adoption, a comparison of Bush's record to that of his five immediate predecessors reveals that, for whatever reason, he never confronted Congress directly on spending. Reagan averaged 10 vetoes per term on spending bills. Even Lyndon Johnson vetoed four bills because of their cost, and two more, in part, for the same reason (see Figure 6).

Right now, a majority in Congress seems energized to control spending. Judging from history, however, this resolve will soon pass. Then it will be up to Bill Clinton to impose budgetary discipline—as only a president can—through strategic use (or threatened use) of the veto. If Clinton expects to control spending, he must be prepared to veto spending bills, even if they are sent up to him by his fellow Democrats.

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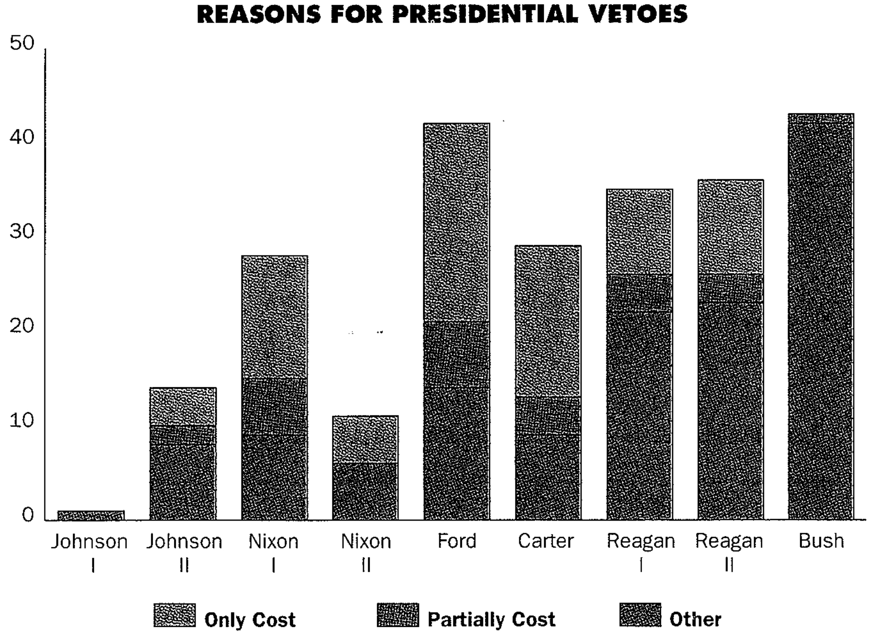
FIGURE 7
REASONS FOR PRESIDENTIAL VETOES



Source: U.S Senate Library; Presidential Papers.
Note: Total vetoes include regular and pocket and exclude bills to reimburse private citizens and companies.