Twenty Years after Humphrey-Hawkins

An Assessment of Fiscal Policy

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The combination of the Great Depression and the Keynesian revolution stripped most economists and politicians of their belief in the stability of the private economy and legitimized the use of stabilization policies to counteract macroeconomic fluctuations. Such policies gained legal standing and substance with the passage of the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act), both of which commit the U.S. government to use fiscal and monetary policies to achieve the goals of full employment, price stability, and economic growth.

Yet, since the passage of those acts, many economists have questioned the efficacy of stabilization policies. The dual challenges of rational expectations theory and Ricardian equivalence, in particular, gave rise to the possibility—or the certainty, according to some economists—of policy "neutrality." Although the determination of policy effectiveness, or the lack thereof, is surely important, the emphasis on these worthy questions has been misplaced. A more important question is whether stabilization policies are even implemented in congruence with short-run macroeconomic objectives. In this article I argue that political pressures in democratic government make the "proper" implementation of stabilizing fiscal policies highly improbable.[1] Specifically, pressures to satisfy constituents will consistently result in high levels of

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government spending, inadequate tax revenues to fund that spending, and the appeasement of politically effective interest groups, all of which supplant fiscal policies that might genuinely attenuate the fluctuations of the business cycle.

In what follows I briefly review the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978, highlighting their emphasis on government's commitment to full employment, and then discuss criteria for effective stabilization policy and the obstacles to such policies in a democratic political setting. Next, I investigate whether fiscal policy since 1978 has been countercyclical and examine six key pieces of fiscal legislation to determine how well they meet the criteria developed earlier.

Macroeconomic Stabilization and Fiscal Policy Legislation

In the aftermath of the Great Depression and World War II, the national government undertook an unprecedented responsibility to promote the economic good of the nation, enacting the Employment Act of 1946. The act explicitly declares that "it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essentials of national policy . . . to promote maximum employment, production, and purchasing power." To facilitate the achievement of this goal, the act required publication of the *Economic Report of the President,* created the Joint Committee on the *Economic Report,* and established the Council of Economic Advisors, which has the responsibility (among others) "to develop and recommend to the President national economic policies . . . to avoid economic fluctuations or diminish the effects thereof." Writing from a historical perspective, Bradford De Long goes so far as to say that the act provided a "signal" that "an administration that failed to achieve acceptable macroeconomic performance was a failed administration" (1996, 51).

Reacting to the high unemployment and inflation of the 1970s, the federal government recommitted itself to the goals of full employment, economic growth, and price stability with the passage of the Full Employment and Balanced Growth Act of 1978. Like its predecessor, the act places the responsibility for macroeconomic performance squarely on the national government. Unlike its predecessor, however, the 1978 act set numerical targets of no more than 4 percent unemployment and 3 percent inflation by 1983, with the inflation target to be reduced to zero by 1988. In its discussion of the president's budget, the act declares that "the expenditure and revenue elements of the President's Budget shall be developed to promote the purposes, policies, and goals of the Full Employment and Balanced Growth Act of 1978" and that the "size of the President's expenditure and revenue proposals . . . shall be determined in a manner which gives consideration to the needs of the economy."

1. An examination of the implementation of monetary policy would be equally important but is beyond the scope of this article.

At the same time the act recognized the inadequacy of fiscal and monetary policies alone to attain full employment. To supplement those traditional policies, a number of "supplementary programs and policies" were proposed, including countercyclical employment policies, regional and structural employment policies, and youth employment policies, among others. Thus the 1978 act was larger, more complex, and more specific than its predecessor.[2]

The Criteria for and Obstacles to Stabilizing Fiscal Policy

The Criteria

For illustrative purposes, it is helpful to consider, as John Maynard Keynes apparently did, a "straw man" as policy maker. This straw man of policy is wise and benevolent, seeking to smooth economic fluctuations for the common good and completely without regard to his own interests. The illustration is further extended by assuming a citizenry of straw, a people who are unafflicted by rational ignorance of long-term policy effects and who never seek redistributive gains by means of policies with narrowly focused benefits.

For the sake of argument, I will assume the efficacy of fiscal policy for stabilization purposes, deliberately ignoring the implications of rational expectations and Ricardian equivalence theories. In this idealistic setting, fiscal policy will necessarily be conducted according to two principles. First, government budgets will exhibit a clear countercyclical pattern. In recessions, the government will raise spending or lower taxes to create a deficit that, according to standard Keynesian theory, will stimulate the economy, helping to restore full employment and economic growth. In times of growth and prosperity, especially if inflation is occurring, the government will cut spending or raise taxes, yielding a surplus that restrains growth and inflation.[3]

A second principle is that policies to change spending and taxes should be broadly based. To spend on programs that provide relatively more benefits to some than to others or to tax some more heavily than others is to introduce redistributional actions inconsistent with the more public-spirited objective of macroeconomic stabilization.

Adherence to these principles should yield appropriation and tax policies that are brief and simple. Complex spending formulas, "pork-barrel" projects, and multivolume tax codes should be alien to the policy maker and the citizen alike. The cause and (intended) effects of any fiscal policy should be easily known and understood. No citizen should ever worry about whether he (individually) will be "better off" or "worse off" under an upcoming year's fiscal regime. Spending cuts and tax

2. Higgs (1987) provides theory and evidence that government intervention in the economy tends to accompany crises. Therefore, it is not surprising that these acts were passed in the wake of the Great Depression and the high rates of unemployment and inflation experienced in the 1970s.

3. Ben Bolch (1998) writes that the "perfectionist Keynesian vision [of demand management by government] remains so taken for granted that in the vast majority of undergraduate macroeconomics courses, government control of the business cycle is treated as both proper and efficacious" (495).

increases may make citizens worse off, but in a predictable and proportionate way. Likewise, spending increases and tax cuts might improve citizens' welfare, but the improvements would be easily discerned and would yield no relative advantage to one citizen over another. Fiscal policies would simply serve the public interest by mitigating economic fluctuations.

The Obstacles

To any American who has struggled with a 1040 form (even a 1040EZ) or contemplated the impact of an "omnibus budget reconciliation bill" on his personal finances, the policy maker of straw is as easily blown down as the pig's straw house in the childhood story.[4] The wisdom of the policy maker is uncertain; his benevolence is surely suspect. Moreover, citizens are not fully informed of policies and their effects, in either the short run or the long run, nor are they dispassionate participants in the political process.[5]

When policy is influenced by politics, as it must be in a democracy, its content and effects will not correspond to those that would result from a disinterested application of Keynesian policy prescriptions. James Buchanan and Richard Wagner (1977) argue forcefully that the political pressures placed on legislators and presidents yield an asymmetry in the implementation of fiscal policy: the government creates stimulative budget deficits not only in recessions, as the wise and benevolent policy maker would surely and rightly do, but also in times of prosperity. Spending increases and tax cuts yield votes regardless of the economic setting, resulting in continual deficits, an expanding public sector, and inflation.[6] In essence, political pressures preclude the possibility of countercyclical fiscal policy.[7]

George Stigler (1973) argues that countercyclical policies may not be observed because they yield little political benefit. He reasons that macroeconomic fluctuations

4. As I write this passage my desk holds at least three pamphlets attempting to explain the Taxpayer Relief Act of 1997.

5. That participants in the political process pursue their self-interest there, just as they do when participating in the market, has long been recognized. For a seminal discussion, see Buchanan and Tullock 1962, chapter 3.

6. William Keech's (1995) insightful analysis of democracy's effects on macroeconomic outcomes emphasizes that democracy is neither a necessary nor a sufficient condition for fiscal irresponsibility; but in the spirit of Buchanan and Wagner, Keech argues that once informal rules against deficits are broken, democratic institutions may offer little hope of resolving the problem.

7. A complementary literature hypothesizes that because of political pressures, macroeconomic policies are timed to influence electoral outcomes. In seminal articles, William Nordhaus (1975) and Duncan MacRae (1977) argued that policy makers attempt to lower unemployment before elections, only to let it rise afterward to fight inflation. Evidence of a political business cycle, however, is hardly overwhelming. Neither Bennett McCallum (1978) nor Nathaniel Beck (1982) finds supportive evidence, and in an exhaustive series of tests, Alberto Alesina and Nouriel Roubini with Gerald Cohen (1997) find no supportive evidence for the United States and only limited supporting evidence for a sample of eighteen OECD countries. Further, Martin Paldam (1981) argues for and presents evidence of stimulative policies just *after* an election. He explains this counterintuitive result as promise-keeping behavior by legislators who believe that voters have long memories.

are short-lived, that those adversely affected by recessions are relatively few and may be unlikely to vote, that some voters may benefit from a recession (for example, those who keep their jobs and enjoy lower inflation), and that recessions may have genuinely external causes. What clearly must matter, in Stigler's view, are redistributional policies that affect relatively narrow groups and interests. In those cases, benefits are focused and political rewards high.[8]

In a democracy, the problems of political motivation and influence are further compounded by the slowness with which democratic institutions act, so that even well-intended and wisely formed policies may be poorly timed. "Inside lags," the time necessary to determine macroeconomic conditions and formulate policy responses, may be long. Further, once enacted, policies affect the economy only after another time lag, the "outside lag."

On the other hand, automatic stabilization policies may circumvent political motives and time lags by requiring higher spending and lower tax revenues in recessions and the opposite during times of prosperity (for example, through the cyclical variation of unemployment compensation benefits and personal and corporate income taxes). Whether deliberate or inadvertent, automatic fiscal stabilization policies amount to an advance commitment by policy makers to smooth economic fluctuations.

In the remainder of this article I examine the effects of politics on the two policy issues I have raised. In particular, has fiscal policy been countercyclical, and have fiscal policies been broadly based? The answer in both cases is an unequivocal no. The evidence, strictly interpreted, reveals a persistent bias in favor of budget deficits regardless of economic conditions. However, a less restrictive interpretation of fiscal policy, focused on changes in the deficit, shows that countercyclical policies have been carried out sixteen times over the past twenty years. The evidence also reveals that fiscal policies have been shaped by political pressures to achieve a host of unrelated goals and to satisfy a plethora of narrow interests. Examination of one key piece of fiscal legislation in each presidential term since 1978 will demonstrate a multifaceted fiscal policy rooted in the desire for income redistribution, for "social engineering" (for example, spending with the ostensible goal of improving education), and for the support of interest groups as diverse as the oil industry and Vietnam veterans.

Has Fiscal Policy Been Countercyclical?

First, we ask whether fiscal policy has been conducted according to Keynesian principles. As shown in table 1, the federal government has run deficits every year since the

8. Support for Stigler's view is also mixed. Ray Fair (1978) and Mark Crain, Thomas Deaton, and Robert Tollison (1978) find that macroeconomic variables do influence presidential elections. James Kuklinski and Darrell West (1981) find that prospective economic conditions affect Senate elections but not House elections. In the spirit of Stigler, they suggest that House members are held accountable for serving constituent interests whereas senators are held responsible for national problems.

passage of Humphrey-Hawkins, with the exception of 1998, regardless of macroeconomic performance. Prior to 1998, the most recent surplus occurred in 1969. Indeed, the real deficit and the growth of real GDP are both negative only in 1980, 1982, and 1991, and both positive only in 1998—hardly consistent with Keynesian countercyclical policy. Estimating a simple regression of the real deficit against the change of real GDP from 1979 to 1998 reveals an insignificant relationship, as evidenced by an F-statistic of 0.973. Buchanan and Wagner's hypothesis seems strongly supported.

Table 1: Government Deficits and Macroeconomic Conditions

Year	Deficit or Surplus	Change in Real Deficit	Growth in Real GDP	Unemployment Rate	Inflation Rate
1978	–59	–3.0	5.37	6.1	7.6
1979	–41	42.6*	2.83	5.8	11.3
1980	–74	–48.7*	–0.34	7.1	13.5
1981	–79	2.7	2.29	7.6	10.3
1982	–128	–62.6*	–2.13	9.7	6.2
1983	–208	–101.8	3.97	9.6	3.2
1984	–185	40.4*	7.00	7.5	4.3
1985	–212	–26.3	3.57	7.2	3.6
1986	–221	–4.1	3.08	7.0	1.9
1987	–150	93.7*	2.95	6.2	3.6
1988	–155	0.5*	3.82	5.5	4.1
1989	–153	9.5*	3.36	5.3	4.8
1990	–221	–65.5*	1.23	5.6	5.4
1991	–269	–40.4*	–0.93	6.8	4.2
1992	–290	–13.5*	2.71	7.5	3.0
1993	–255	41.5*	2.33	6.9	3.0
1994	–203	55.4*	3.46	6.1	2.6
1995	–164	41.0*	2.28	5.6	2.8
1996	–107	55.0*	3.45	5.4	3.0
1997	–22	77.6*	3.93	4.9	2.3
1998	69	80.9*	3.88	4.5	1.6

Sources: Facts and Figures on Government Finance, 32d edition, table C1, with updates provided by the Tax Foundation; and the 1999 issue of *The Economic Report of the President*, table B-2 (real GDP growth), table B-42 (unemployment rate), table B-63 (inflation rate), and table B-78 (deficit).

Note: Deficit/surplus figures are in billions of dollars. Nominal deficit figures are given in the first column, but the changes in the deficit are in real terms (negative numbers signify increases; positive numbers, decreases of the real deficit). Asterisk designates countercyclical change in the real deficit.

Yet, advocates of activist fiscal policy might counter that what matters is the *response* of fiscal policy to changes in economic conditions. Though deficits have been endemic through the last two-thirds of the twentieth century, the more important question may be whether deficits increased during economic downturns and decreased during economic expansions. Application of this less stringent standard reveals a relatively countercyclical fiscal policy. As shown in table 1, positive correlations are clear and fairly consistent: from 1979 to 1998, changes in the deficit have corresponded to changes in real GDP or in the unemployment rate in a way that is qualitatively countercyclical for sixteen of twenty years. Only in 1983, 1985, and 1986 did the deficit increase while real GDP grew and the unemployment rate declined. Fiscal policy in 1981 is also best considered procyclical, because the decline in the real deficit is accompanied by a 0.5 percentage point rise in the unemployment rate despite the increase in real GDP. (Although 1990 and 1992 are years of rising deficits and positive real GDP growth, these increases in the deficit are best interpreted as countercyclical because the unemployment rate rose in each year.) A simple regression of changes in the real deficit against changes in real GDP for 1979 to 1998 is significant; the resulting F-statistic is 10.006. When the independent variable is switched to the change in the unemployment rate, the F-statistic is even higher at 11.274.

Historical Analyses

Let us now turn to a historical examination of fiscal policy. Detailed data on spending and tax revenues are provided in tables A1 and A2 in the appendix.

The early 1980s brought a severe recession. A combination of higher defense and mandated spending, along with reductions or only small increases in individual income tax collections and plummeting corporate tax revenues yielded sharp and, in the Keynesian perspective, appropriate rises in the deficit in 1980 and 1982. As stated earlier, the slight decrease in the real deficit in 1981, which stemmed largely from a short-lived economic rebound that drove up individual income tax collections, is best considered procyclical because of the concurrently rising unemployment and the temporary and weak character of the economy's growth. Therefore, the stabilizing influence of fiscal policy in the early 1980s was only partial.

The ensuing years of the 1980s brought strong economic growth, presided over by a president verbally committed to balancing the budget. If ever the budget should have been balanced, those were the years. (Recall: "If not us, who? If not now, when?") Yet, such was not the case; rather deficits rose to record levels. Even changes in the deficit in 1983, 1985, and 1986 were procyclical, as higher spending across all categories (nondefense discretionary spending in 1983 and 1986 excepted) outstripped rising tax revenues. By the end of the decade the deficit was falling, mainly because of large gains in individual-income, corporate-income, and social-insurance taxes, which offset higher mandated and interest expenditures.

Economic growth slowed again in 1990, and the economy entered a mild recession in 1991. Fiscal policy was countercyclical: deficits rose along with the unemployment rate through 1992. Again, higher mandated expenditures along with sluggish or negative growth in tax revenues generated extraordinarily high deficits.

As in the mid- to late 1980s, the years following the early-1990s recession brought strong economic growth and, accordingly, steadily declining real deficits. Finally, in 1998, the government ran a fiscal surplus. The decline in the deficit and the ultimate surplus again resulted largely from automatic policies, as individual-income, corporate-income, and social-insurance taxes all posted large gains throughout the decade, though declining defense spending also contributed to the marked deficit reduction.

To summarize, with the exception of 1998, every year since passage of the Humphrey-Hawkins bill has brought stimulative fiscal policy, as evidenced by continued deficits, even during periods of prolonged expansion in the 1980s and 1990s. On the strength of this evidence one might conclude that the notion that fiscal policy is used to stabilize the macroeconomy is demonstrably false. Nevertheless, if a less stringent standard—the change in the real deficit—is used to evaluate fiscal policy, the evidence reveals a primarily countercyclical policy: deficits generally widen during recessions and contract during expansions.

The Question of Lags

This contemporaneous analysis may, however, be questioned on grounds that discretionary fiscal policy can be implemented only after a time lag. To account for this consideration, I examined fiscal policies after one-year and two-year lags to determine how lagged values correspond to countercyclical ideals. Perhaps surprisingly, countercyclical policy is observed even less often when changes in the real deficit are compared to lagged values of real GDP growth and changes in the unemployment rate. Specifically, when a one-year lag is considered (reducing the sample period to 1980 to 1998), procyclical policy is observed in six years: 1980–81, 1985–86, 1990, and 1993. When a two-year lag is considered (reducing the sample to 1981 to 1998), procyclical policy is observed in seven years: 1984–86, 1990–91, and 1993–94. Countercyclical fiscal policy is clearly more evident when contemporary changes in deficits are compared to contemporary rates of GDP growth and unemployment.[9]

Automatic versus Discretionary Fiscal Policy

The prominent roles of mandated spending, individual and corporate income tax collections, and social-insurance tax collections in the historical analysis, along with the lack of evidence correlating current changes in deficits to past economic conditions, all

9. See Keech (1995, 160–62) for evidence that all expansionary countercyclical fiscal initiatives since World War II were enacted after the corresponding recessions were over.

point to the relative significance of automatic fiscal policy over discretionary fiscal policy. Indeed, De Long writes that historically "it is difficult to argue that on balance 'discretionary' fiscal policy has played *any* stabilizing role" and that the role of automatic stabilizers is important because of the federal budget's large size (1996, 45–47; italics in original). Because of the relative importance of automatic fiscal policy, I briefly analyze some of its components.

Inspection of the data reveals that countercyclical automatic fiscal policy results more from changes in tax revenues than from changes in mandated spending. Changes in individual-income, corporate-income, or social-insurance tax revenues, either singularly or in combination, have been countercyclical in at least thirteen of the last twenty years, despite less-than-stellar performance during recessions, such as when individual income taxes rose in 1980, corporate income taxes rose in 1991, and social-insurance taxes rose in 1980, 1982, and 1991. On the other hand, mandated spending has been procyclical in eleven of twenty years, despite countercyclical movements in 1980, 1982, and 1991. Mandated expenditures are of dubious use as a tool of stabilization policy, no doubt because of prominent entitlement programs such as Social Security, Medicare, and veterans' benefits, which together accounted for an estimated 37.1 percent of federal outlays by 1998, compared to just under 30 percent in 1979.[10] Countercyclical policy is apparently more easily achieved in the realm of taxes.

What role does nondefense discretionary spending play in stabilization policy? First, notice that with mandates and interest currently accounting for approximately two-thirds of federal outlays (up from 52.5 percent in 1979), the scope of discretionary spending is limited.[11] Indeed, nondefense discretionary expenditures fell from just under one-quarter of total outlays in 1979 to just over 17 percent in 1998.[12] A far worse problem, however, is the procyclical pattern of nondefense discretionary spending, which is evident for eleven of the past twenty years, including the recession year 1982. For a spending category arguably most subject to manipulation in the pursuit of macroeconomic policy goals, "getting it right" less than half the time suggests an unwillingness or inability of the Congress, the president, or both to use discretionary spending for stabilization purposes.

Although a policy of advance commitment to macroeconomic stabilization could hardly have been intended when the country's tax structure and many of its social programs were established during the early decades of this century, those automatic policies, rather than the discretionary ones, have been primarily responsible for any stabilizing effects of fiscal policy.

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10. See the 1986 issue of the *Economic Report of the President,* table B-74, and the 1999 issue of the *Economic Report of the President,* table B-81.

11. See table C-5 of *Facts and Figures on Government Finance,* 32d edition. The 1998 estimate was provided by the Tax Foundation.

12. See table C-5 of *Facts and Figures on Government Finance,* 32d edition. The 1998 estimate was provided by the Tax Foundation.

A Closer Look at Key Fiscal Legislation

To highlight the uses of fiscal policy that are clearly inconsistent with macroeconomic stabilization, in this section I review a single major tax or budget act for every presidential term since the passage of the Humphrey-Hawkins Act. My purpose is not to offer a comprehensive account of the content or impact of the various acts, but rather to show that fiscal policy is a flexible and multifaceted policy tool whose objectives diverge widely from the straightforward goal of macroeconomic stabilization.

The Revenue Act of 1978

In his message to Congress in support of the Revenue Act of 1978, President Carter proposed tax reforms aimed at "sustaining our economic recovery" (Carter 1978, 23-E). With the unemployment rate at 6.1 percent and falling, real GDP growth at 5.0 percent, and the rate of inflation at 7.6 percent and rising (1978 figures), it is questionable how much "sustaining" the recovery needed. Yet, Carter spoke of individual and business tax cuts to reduce unemployment below 6 percent and to stimulate economic growth to historically unsustainable rates of 4.5 to 5.0 percent. In addition, he proposed making the tax system "fairer and simpler" (Carter 1978, 23-E).

The 1978 revenue act touched on individual income taxes, business taxes, and a host of other tax provisions. On net, the act cut taxes by an estimated $18.7 billion—a substantial amount, though still insufficient to offset rising Social Security taxes and increases of income tax liability as inflation pushed taxpayers into higher brackets. Congressmen Charles Vanik (D-Ohio) and J. J. Pickle (D-Tex.) wanted no tax cut, arguing that the cuts were politically motivated and inflationary. Vanik said, "It is regrettable that we have to be acting on a tax reduction bill this close to an election," and proposed a rule that "no tax cut bill can be considered by the Congress within six months of an election" (Congress Approves Tax Cut, 233). Clearly, these tax cuts in a booming economy experiencing historically high inflation illustrate an asymmetric application of fiscal policy, consistent with the theory set forth by Buchanan and Wagner.

By the standard that broadly based changes in tax policy are less subject to political manipulation than narrowly targeted changes, the Revenue Act of 1978 stands as an example of the latter. In a reversal of trend, the act tended to favor wealthy taxpayers over poor ones, in particular by reducing taxes on capital gains. This cut and other tax-cutting provisions were decried by liberal members of Congress, such as Ted Kennedy (D-Mass.) and James Jones (D-Okla.). Jones stated, "I'm not sure I can justify them [tax cuts] economically, but politically they strengthen the bill" (229). Despite the class-charged controversy surrounding the capital gains tax cuts, Congress did help the poor by expanding the earned-income tax credit.

Changes in business taxes vividly highlighted the pursuit of social objectives and special-interest legislation. For example, while Congress made the investment tax credit permanent and more generous for all investments, environmental policy was served by a still more generous tax credit for the purchase of pollution-control equipment. To aid urban renewal, Congress, with the approval of the president, extended the application of the investment tax credit to the rehabilitation of commercial and industrial buildings in downtown areas. Congress also provided benefits to the underclass through "targeted job credits" that subsidized labor costs for employers who hired disadvantaged individuals. These persons included "supplemental security income (SSI) recipients, welfare recipients, handicapped people undergoing vocational rehabilitation, and disadvantaged individuals 18–25, Vietnam veterans under 35, convicts released from custody within the past five years and certain students aged 16–18" (221).

Narrowly targeted provisions were many, even if their consequences for revenues were trivial. For example, the act granted special tax provisions and benefits to Arkansas College, the Gallo (wine-producing) family of California, a long-term care facility in Oklahoma, farmers in Michigan, and employees receiving employer-paid education.

The Economic Recovery Tax Act of 1981

If any recent fiscal legislation had the opportunity to implement expansionary countercyclical policy, it was the Economic Recovery Tax Act of 1981. Enacted in the midst of the country's worst recession since the Great Depression, the act did provide relatively straightforward tax cuts.

Specifically, the act provided broad-based cuts in individual income taxes of 5 percent in 1981, 10 percent in 1982, and an additional 10 percent in 1983. The bill also indexed individual income tax brackets to compensate for inflation. Recognizing the potential for fiscal policy to redistribute income, President Reagan contrasted this legislation with prior tax packages as "not merely a shift of wealth between different sets of taxpayers" but a "proposal for an equal reduction in everyone's tax rates [that] will expand our national prosperity, enlarge national incomes, and increase opportunities for all Americans" (Reagan 1981, 17-E). He argued that the government's taxing power "must not be used to regulate the economy or bring about social change" (18-E). Although the tax cuts were cast with a supply-side emphasis, they also represent a case of countercyclical, demand-side policy.

Despite Reagan's rhetoric and the generally countercyclical and broad provisions of the act, however, the legislation was littered with accommodations of interest groups, even if those accommodations and their impacts were relatively minor. Business support was garnered generally by the inclusion of accelerated depreciation schedules for investment spending, while specific industries received special benefits. For example, trucking firms were allowed a deduction to compensate for the devaluation of their licenses by deregulation, and oil firms were partially relieved of windfall profits taxes.

Nor were social objectives absent from the bill. Deposit intermediaries were permitted to offer savings certificates paying 70 percent of the yield on one-year Treasury bills, so long as 75 percent of the new deposits went to home or agricultural loans. In addition, companies that leased transportation equipment to mass-transit systems were allowed to finance their equipment with tax-exempt bonds. And a deduction was created for parents who incurred expenses in adopting "hard-to-place" children.

However fair or meritorious those provisions may seem, they are indicative of a legislative process influenced not only by macroeconomic conditions but also by rent seeking and ideals of the "public good." Fiscal policy, even at its best, is far from pure.

The Tax Reform Act of 1986

Heralded as one of the most important pieces of tax legislation in U.S. history, the Tax Reform Act of 1986 dramatically reduced income tax rates. The maximum marginal tax rate for individuals fell from 50 percent to 28 percent, the maximum marginal rate for corporations from 46 percent to 34 percent. The act also curbed tax breaks and, by the assessment of many, made the tax code fairer.[13] Consideration of stabilization policy was conspicuously absent from the bill.

With real GDP growing at its long-run-trend rate of 3 percent and the inflation rate at its lowest since 1965, it is understandable that an expansionary discretionary fiscal policy was not undertaken. Less explicable is why Congress failed to take steps to lower a (nominal) deficit in excess of $200 billion with the economy in the midst of an eight-year expansion. The Senate did express a concern by passing (by a 72–24 margin) a nonbinding resolution to delay action on the tax bill "until a firm, definite budget agreement has been reached" (Congress Enacts Overhaul, 508). The Senate's zeal, however, proved short-lived, and when confronted with Reagan's opposition to a tax increase, the resolution proved not only nonbinding but ineffective. In the end, the president and Congress agreed that the act should have no impact on federal tax collections, a principle known as revenue neutrality.[14]

Adherence to revenue neutrality may have limited the inclusion of redistributive and social policies in the act, but it did not eliminate them. Of particular importance, the bill exempted six million people from tax liability by raising the personal exemption and the standard deduction and by indexing both for inflation. The act also raised the earned-income tax credit and extended job credits. To further help the poor, the act granted tax credits to landlords who owned rental housing occupied by low-income tenants. And to add a special penalty on the rich, the act assessed a tax (10 percent) on pension benefits

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13. James Long (1997) concludes that the net changes in the tax base and tax rates made the tax system more progressive.

14. Failure to reduce the deficit may contribute to another fiscal problem: when deficits are already high, implementation of expansionary fiscal policy becomes problematic, whether the discipline comes from political or economic constraints (e.g., the bond market), as the Clinton administration soon discovered when trying to increase public investment spending in its first term. The notion that an administration might intentionally run large deficits to constrain the spending of a succeeding administration has been advanced by Torsten Persson and Lars Svensson (1989).

in excess of $112,500. On the other hand, interest deductions on consumer debt were phased out, while interest on new loans secured by a first or second mortgage continued to be deductible.

Although the act's provisions in general achieved revenue neutrality by closing tax breaks to compensate for reduced rates, the hopes of rent seekers sprang eternal. Indeed, Bob Packwood (R-Ore.), chairman of the Senate Finance Committee, strongly urged a conference agreement before Congress's August recess "so the special interests and lobbyists don't have three weeks to hit on our members to change what is in this most remarkable tax package" (Congress Enacts Overhaul, 520). Some attempts were thwarted, such as the call from John Heinz (R-Pa.) for accelerated depreciation for formal-wear manufacturers, two of which were located in his state. However, in concessions to southwestern and western states, Congress continued its favorable tax treatment of companies engaged in the production of oil, gas, coal, timber, and other natural resources. On the other side of the country, Daniel Moynihan (D-N.Y.) managed to obtain provisions granting special tax breaks for performing artists.

In addition, the Tax Reform Act of 1986 is a prime example of the time-inconsistency problem that may destabilize economic performance.[15] In a reversal of prior stimulative supply-side policies, the act eliminated the investment tax credit for business and circumscribed the deductibility of contributions to individual retirement accounts for individuals covered by a pension plan or with incomes above a minimal level. In another policy change affecting savings, the capital-gains exclusion was eliminated, raising the maximum rate on capital gains from 20 percent to 28 percent. These dramatic shifts of incentives for saving and investment can hardly be deemed stabilizing for the economy.

The sheer complexity of the bill is evidenced by a conference report of two thousand pages and by 682 "transition rules" that eased the effects of the bill on various businesses. In sum, the Tax Reform Act of 1986 represents the pursuit of redistributive and social objectives, interest-group concessions (or denials), and outright policy reversals, rather than countercyclical policy.

The Omnibus Budget Reconciliation Act of 1990

By 1990, nominal deficits had vaulted over the $200 billion mark for the first time since 1986, and President Bush worried that rising deficits might hinder economic growth, thereby damaging his reelection prospects. Democrats too expressed concern about the deficit, but this common concern masked fundamental disagreements over

15. For an excellent discussion of the time-inconsistency problem, see Kydland and Prescott 1977. In a recent paper, Robert Archibald and David Feldman (1998) highlight the effect of policy uncertainty and inconsistency by presenting evidence that uncertainty over the passage of and rates applied by the Smoot-Hawley tariff contributed to the Great Depression by causing a drop in investment spending by firms with high exposure to international trade.

budget policy. The 1990 budget deal, "the centerpiece of the year's fiscal work," proved, perhaps, the most contentious and partisan of recent decades (Budget Adopted, 111). The struggle pitted a Republican president who had promised the American people "no new taxes" against a Democratic Congress ostensibly more concerned with "tax equity." After months of negotiations and summit meetings, all in the shadow of the Gramm-Rudman deficit-reduction law, the president and Congress struck a deal that its framers claimed would cut the deficit by $496.2 billion over five years.

Nevertheless, closer examination indicates that the budget deal was not a serious deficit-reduction effort. The act arguably raised dicretionary spending and did nothing to stop escalating entitlement spending. As shown in appendix table A1, real government outlays rose by almost $43 billion in the two years following the budget deal and, with the exception of 1993, have risen every year since 1990.

The act did, however, give the appearance of being a deficit-reduction measure. Title 13 of the act, referred to as the Budget Enforcement Act (BEA), attempted to control spending by setting nonsubstitutable caps for three categories of discretionary spending (defense, international, and domestic) and by requiring that new mandatory spending be financed either by cuts in existing programs or by new revenues, a provision known as "pay-as-you-go."[16] Some analysts argue that these provisions have helped to reduce the deficit and that the early-1990s recession and rising health care costs alone explain the rising real deficits of 1991–92.[17]

Other analysts, however, show that, to the contrary, the BEA "did not reduce the deficit by the $400–$500 billion (over five years) claimed by its framers" (Schick 1992, 22, 24). The reasons are many. First, defense spending caps were set against unrealistically high baselines, so that "what was billed as a cutback turns out to have been a spending increase" (25). Second, caps for domestic spending were set about $42 billion above baseline levels. Although the spending caps may have held, it is absurd to argue they helped to reduce the deficit when they were set at such high levels. In the end, "the president got more for defense, the Democrats got more for domestic programs, and both sides celebrated their gutsy decision to curtail the deficit" (27). Third, domestic spending caps, once set, were adjusted upward by more than $100 billion, mostly because of emergency spending for operations Desert Shield and Desert Storm and for disaster relief (Oak 1995). Finally, and perhaps of greatest importance, the BEA did not stop the growth of existing entitlement spending, including guarantees of deposit insurance. These (mostly indexed) programs continue to grow as new beneficiaries qualify and as costs, especially health care costs, continue to rise. The act produced what Richard Doyle and Jerry McCaffery (1991) have called "no-fault budgeting," which shields politicians from the respon-

16. For a detailed discussion of the Budget Enforcement Act, see Doyle and McCaffery 1991.

17. For an elaboration of this view, see Davis 1997.

sibility for higher spending and deficits so long as they adhere to spending caps and the pay-as-you-go provision.

But if attention to deficit reduction was more token than real, the influence of redistributional and social objectives proved vigorous. The most significant changes affected personal income taxes, where Democrats' desire for more income redistribution and progressivity in the tax system triumphed over Republicans' desire for lower capital-gains taxes to stimulate saving and economic growth. The act raised marginal tax rates on upper-income Americans from 28 percent to 31 percent and, with complicated formulas, cut the exemptions and limited the itemized deductions available to upper-income taxpayers. The capital-gains tax rate was reduced to 28 percent for all investors, but the reduction was meaningless to the vast majority of Americans, who were already in the 28 percent bracket or lower. The "soak the rich" strategy was reinforced by a 10 percent luxury tax assessed on purchases of fur, jewelry, automobiles, airplanes, and boats priced above certain threshold levels.

Although the act moderately raised the cost of Medicare to beneficiaries, it continued the trend of aid to the poor. The act expanded the earned-income tax credit and extended tax credits for targeted jobs and for the construction or rehabilitation of low-income housing. In addition, the act implemented a $22.5 billion (over five years) "child care package" (Budget Adopted, 139–40).

Other provisions reflected social objectives and interest-group pressures. The environmentalist lobby fared well under the act: cars that did not meet legislated fuel-economy standards were taxed at a higher rate, as were ozone-depleting chemicals, and tax credits were extended for the production of alternative fuels. The trucking industry successfully lobbied for and benefited from application of the fuels tax to railroads. And, the act targeted "vices" as a source of revenue, raising excise taxes on alcohol, tobacco, and gasoline.

The political motives underlying many of the act's provisions yield an instructive insight into the formation of fiscal policy. Bush apparently wanted deficit reduction to stimulate growth and enhance his reelection prospects, but not at the cost of lower defense spending. Congress too used the budget deal to improve incumbents' reelection prospects. During the reconciliation process, "House floor debate was less about probability than about scoring political points that would serve candidates' interests in the elections" (164). Democrats privately admitted that "a rate hike would . . . be the most direct way to remind voters that Bush had to renege on his 'no-new-taxes' campaign pledge" (169). Again, politics, not macroeconomic conditions, determined budgetary outcomes.

The Omnibus Budget Reconciliation Act of 1993

In 1993 deficit reduction continued to be a matter of concern. Arguably, deficit reduction was the appropriate fiscal policy for 1993, because the economy had clearly emerged from its recent recession. In the end, the budget act targeted deficit reduction of $504.8 billion over five years through $250.1 billion in new revenues and $254.7 billion in spending cuts. The act also extended the caps on discretionary spending and the pay-as-you-go provision of the 1990 budget deal through 1998. Though the act was generally countercyclical, a close examination shows that it was also filled with spending and tax provisions that catered to special-interest groups and that gave ample opportunity for members of Congress and the Clinton administration to achieve social objectives unrelated to macroeconomic performance.

The burdens of deficit reduction were not imposed evenly. The bill, consonant with Clinton's wishes, made the tax system more progressive by creating additional tax brackets of 36 percent and 39.6 percent for high-income individuals and families. Those narrowly applicable tax rates point to the dual goals of lower deficits and a more egalitarian distribution of after-tax income. Indeed, Clinton helped to sell the plan by reminding the majority of Americans that only the wealthy would pay higher taxes.

Though the act did trim Medicare spending by more than $49 billion over five years, other programs, such as the earned-income tax credit, expanded significantly. And the act not only expanded existing programs; it also created a new entitlement to fund programs that contributed to "family preservation," such as programs aiding adoptive families, foster children, and neglected and abused children.

In other provisions, the tax credit for hiring "hard-to-employ" workers was extended yet again, as was a provision allowing employees to deduct employer-provided educational benefits from their taxable incomes. The tax credit for developers who renovated housing for the poor was made permanent. And to attract capital to low-income areas, the legislation, blatantly disregarding market forces, created 104 "empowerment zones." Tax breaks and grants would be awarded to businesses that invested in and hired from these HUD-designated areas. The budgetary cost of these social programs may have been small, but consideration of only their budgetary cost ignores the costs of resource misallocation.

If President Clinton's redistributive agenda was advanced by the adoption of a more progressive tax code, greater spending on selected social programs, and incentive-induced diversions of private resources to impoverished areas, his environmental agenda did not fare so well. The president had proposed a "carbon tax" (or Btu tax) on energy not only to raise government revenues, but also to reduce emissions of greenhouse gases. From the House Ways and Means Committee to the Senate floor, a wide array of energy-using and -producing industries assaulted any attempt to raise energy taxes. By the time the bill emerged from the conference committee, the energy tax had been reduced to a relatively moderate 4.3-cent-per-gallon hike on most fuels; and the airline industry, aided by the support of Slade Gorton (R-Wash.), had been granted a temporary exemption for jet fuel.

The 1993 Budget Reconciliation Act provides an example of countercyclical fiscal policy characterized by cuts in government spending and increases in taxes in a growing economy already plagued by large deficits. But the act also demonstrates the use of fiscal policy to achieve (or attempt to achieve) a variety of social objectives, from a more progressive tax system to a cleaner environment. The question of how meritorious these social objectives may be is normative. However one answers the normative question, the act clearly shows that fiscal outcomes are the outgrowth of a complex interaction between multiple interests and political objectives, only one of which may be the stabilization of the macroeconomy.

The Taxpayer Relief Act of 1997

With the economy still growing briskly into Clinton's second term, the feasibility of a balanced budget became more promising and then took on legislative reality in the form of the 1997 budget deal. In a rare display of bipartisan cooperation, Congress and the president agreed to appropriations and tax bills scheduled to balance the budget by 2002. Nevertheless, with deficits projected for the interim (the 1997 deficit was lower than initially anticipated), $96 billion in tax cuts, and no reform of entitlement spending, the budget could hardly be called countercyclical. Of the 1997 budget deal, one conservative Democrat, Charles Stenholm of Texas, commented, "I am disappointed that we missed the opportunity to make real reforms in the long-term costs of entitlements" (Rubin 1997, 1184). As a result, any period of surpluses may be short-lived.[18]

Indeed, the 1997 legislation made no pretense of macroeconomic considerations, instead tinkering with a wide array of taxes in ways that clearly reflected social objectives. The act promoted education through tax credits, educational savings accounts, and permission for penalty-free withdrawals from IRAs for educational purposes. In a "pro-family" move, the act provided tax credits for children under age seventeen. And in efforts to encourage savings, the act cut the capital-gains tax for assets held more than one year and established Roth IRAs, which allow principal and interest to be withdrawn tax-free.

To help the poor, the 1997 act extended tax credits to employers who hire from "needy" groups, and it offered wage credits to employers hiring former welfare recipients. Following in the footsteps of the 1993 budget act, the 1997 act increased the number of "empowerment zones" by twenty, though the advantages offered most of the new zones were not quite so great as those created originally.

Of particular note, the act complicated the tax code immensely. "The act created 285 new sections to the tax code and 824 amendments. Thirty-six provisions were retroactive; 114 took effect immediately, and 69 more will become effective Jan. 1 [1998]" (Weisman 1997, 3120). The increased complexity of the tax code is expected to result in greater use of tax accountants and lawyers, a surge of mistakes by taxpayers, and perhaps less compliance.[19] The Taxpayer Relief Act of 1997 reinforces the premise

18. See "Overselling the Surplus," *Economist,* May 30, 1998, 23–24.

19. See Jonathan Weisman, "Experts Calculate Rate of Pain from 'Taxpayer Relief Act,' " *Congressional Quarterly Weekly Report,* December 20, 1997, 3120–22.

that macroeconomic conditions are a minor, if not trivial, consideration in the implementation of fiscal legislation.

Conclusion

For more than fifty years, the national government has accepted the responsibility for U.S. macroeconomic performance, most recently affirming that responsibility in the Humphrey-Hawkins Act of 1978. To believe that truly stabilizing policies will be implemented—completely apart from any assessment of policy effectiveness—requires a nearly complete denial of political realities in a democratic system. Political pressures often impede the application of countercyclical policies, because large deficits are popular in expansions as well as in recessions. In addition, social objectives and interest-group pressures override the broader and more public-spirited concern for macroeconomic stabilization. Evidence from the last twenty years reveals a pattern of large and consistent deficits and fiscal legislation characterized by narrowly targeted spending programs and tax breaks.

Fiscal policy has been countercyclical at times. Nevertheless, those policy successes owe more to the inadvertent precommitment of the tax structure and Depression-era social legislation than to legislative reaction to the macroeconomy. Further, recent efforts ostensibly to reduce the deficit have not controlled entitlement spending. The notion that fiscal policy will be used to stabilize economic fluctuations has little empirical justification. Perhaps it is time for the national government to repeal the Full Employment and Humphrey-Hawkins Acts. Even if the advocates of policy neutrality are mistaken, years of experience show that the implementation of fiscal policy for stabilization purposes is difficult, if not impossible, in a democratic setting.

Appendix

Table A1: Changes in Government Spending

Year	Change in Real Deficit	Change in Outlays	Change in Spending by Type: Defense	Discretionary	Mandated	Interest
1978	–3.0	37.9	–0.2	14.1	17.3	6.7
1979	42.6	11.9	6.1	–0.9	–0.7	7.4
1980	–48.7	66.9	11.6	12.0	33.4	9.9
1981	2.7	47.6	16.2	–7.8	22.1	17.2
1982	–62.6	34.8	25.4	–27.5	19.9	16.8
1983	–101.8	42.0	21.9	–3.5	22.1	1.6
1984	40.4	18.0	13.6	3.4	–22.9	23.7
1985	–26.3	83.3	22.0	7.9	34.9	18.6
1986	–4.1	23.2	17.3	–3.0	5.0	3.8
1987	93.7	–20.5	0.2	–9.9	–9.0	–1.8
1988	0.5	27.9	–2.1	6.9	13.7	9.4
1989	9.5	38.7	1.0	4.5	20.8	12.4
1990	–65.5	63.9	–18.3	8.2	65.9	8.1
1991	–40.4	22.3	8.0	5.3	5.8	3.1
1992	–13.5	20.5	–26.0	12.3	34.8	–0.5
1993	41.5	–8.0	–17.6	10.2	5.0	–5.6
1994	55.4	17.1	–16.4	6.6	27.6	–0.6
1995	41.0	15.3	–14.8	3.5	4.3	22.2
1996	55.0	10.0	–12.4	–8.8	27.8	3.4
1997	77.6	7.2	0.0	2.9	6.2	–1.9
1998	80.9	56.6	–6.2	9.2	55.0	–1.5

Source: Facts and Figures on Government Finance, 32d edition, table C4, with updates provided by the Tax Foundation.

Note: All figures are in billions of real dollars. Figures for 1998 are estimates.

Table A2: Changes in Government Tax Revenues

Year	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes
1978	23.1	2.1	13.0
1979	39.0	1.1	13.9
1980	10.2	–11.9	10.1
1981	28.4	–14.6	15.1
1982	–9.1	–22.5	10.2
1983	–29.4	–19.5	–1.5
1984	–1.5	24.4	29.9
1985	33.0	3.1	22.4
1986	6.9	0.2	14.4
1987	39.4	22.7	12.7
1988	–6.5	8.8	23.3
1989	30.9	5.4	12.4
1990	1.9	–15.3	5.4
1991	–18.0	0.9	0.9
1992	–4.8	–0.5	6.7
1993	20.8	14.2	3.7
1994	20.0	19.1	21.7
1995	30.7	12.1	10.3
1996	48.1	10.3	12.8
1997	59.9	6.1	17.2
1998	25.7	7.3	27.5

Source: Facts and Figures on Government Finance, 32d edition, table C23, with updates provided by the Tax Foundation.

Note: All figures are in billions of real dollars. Figures for 1998 are estimates.

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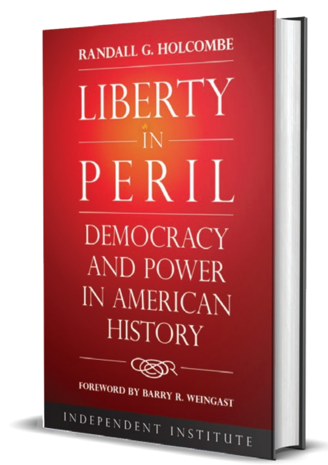

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