Surrender
Meeropol, Michael Allen

Published by University of Michigan Press


For additional information about this book
https://muse.jhu.edu/book/52842

For content related to this chapter
https://muse.jhu.edu/related_content?type=book&id=2002763
George Bush was elected president in part because he promised to continue the Reagan program. He is famous for his promise not to raise taxes no matter how many times the Democrats in Congress asked him to. Just as important was his commitment to using the tax system to stimulate investment. Every year of his presidency, he proposed a reduction in the rate of taxation on capital gains. In the area of regulation, he set up the Council on Competitiveness with Vice President Quayle as the chair. This institution became a clearinghouse for discussions of how to reduce the burdens of regulation so as to increase the ability of American businesses to compete in an increasingly global marketplace. It also became a kind of “appeal of last resort” for business and other interests who felt that new proposed regulations would impose costly burdens not warranted by the benefits to society. In the international arena, he negotiated a free-trade agreement with Canada and then, together with Canada and Mexico, the North American Free Trade Agreement (NAFTA). Early in his presidency he reiterated his belief:

Increased global competition is an opportunity for the United States and the world, not a threat. But we cannot remain competitive by avoiding competition. My Administration will therefore continue to resist calls for protection and managed trade.

He succeeded in persuading the Congress to put NAFTA on a “fast track” for consideration. This meant that the negotiated treaty could only be voted up or down; in other words, Congress could not amend the treaty and force the administration to reopen discussions. The Bush administration also vigorously pursued a new round of negotia-
tions for worldwide reductions in trade barriers under the General Agreement on Tariffs and Trade (GATT).

So far, there is nothing in these actions to distinguish the Bush administration from the rhetoric of the second Reagan administration. In fact, by promoting NAFTA and calling for a capital-gains tax cut, Bush was reversing Reagan, who had increased protectionism and signed the Tax Reform Act. Supply-siders like Robert Bartley and Lawrence Lindsey had disagreed with the part of the 1986 law that had ended the preferential tax rate for capital gains and had warmly approved of Bush’s efforts to reinstitute it. So how was it that conservatives came to regard Bush as a counterrevolutionary, betraying the Reagan legacy? The short answer involves the Deficit Reduction Act of 1990. By signing a law that raised income taxes as part of an agreement to reduce the deficit, President Bush repudiated his “read my lips” promise not to raise taxes. Worse, according to Bartley and Lindsey, he reversed the incentive effects of the Reagan tax policy.

Replacing Gramm-Rudman-Hollings

In 1989, the Bush administration prepared its spending and revenue estimates for the fiscal year 1990. The amended Gramm-Rudman-Hollings Act of 1987 had provided for a deficit target of $100 billion, but the administration estimated that the deficit would exceed that figure by more than the $10 billion margin permitted by the law. Therefore, the president ordered that $16.1 billion be cut (the legal term was sequestered) from federal spending. After months of conflict, Congress came up with a budget reconciliation bill that cut spending to within the Gramm-Rudman-Hollings limit for fiscal 1990, and the president released three-quarters of the sequestered funds. However, by the middle of 1990, it became apparent that the actual deficit for that fiscal year was going to exceed projections. The result was that President Bush and the congressional leadership entered into very intense negotiations aimed at really cutting the deficit. Just as President Bush had warned in his nomination acceptance speech at the Republican convention, the Democratic leadership of Congress insisted that raising taxes on the highest-income Americans so as to make the tax system more fair (in their opinion) was essential if they were to agree to any budget cutting. In addition, they insisted that the president explicitly support such a
move so as to make the increase in taxes bipartisan. President Bush acquiesced, breaking his “read my lips” promise.

The Omnibus Budget Reconciliation Act of 1990 combined fairly stringent rules controlling spending with an increase in taxation. The top marginal tax rate on individual income was raised from 28 percent to 31 percent (the 33 percent “bubble” was abolished), and other tax increases were included as well. The Bush administration predicted that this law would reduce the federal deficit $500 billion over what it would have been if the law had not been enacted. Unbeknownst to the congressional and administration negotiators, the economy had already slipped into recession in the third quarter of 1990. As always occurs during a recession, tax revenues declined well below predictions, and automatic expenditures on transfer payments such as unemployment compensation rose above predictions. In 1991, the Bush administration calculated that even though the structural deficit (which reflects policy) as a percentage of GDP declined in 1990, the actual deficit (which reflects the economy) rose dramatically. By the end of fiscal 1990, the deficit had ballooned to $221.4 billion, compared to the $100 billion target. This rising deficit during fiscal 1990 gave even more of a sense of urgency to the attempt to successfully conclude budget negotiations with Congress. A year earlier, we should remember, the president had invoked the automatic spending cuts (sequesters) in the Gramm-Rudman-Hollings Act and forced Congress to agree to cuts in appropriations. In the fall of 1990, he was focused on building an international coalition to fight the Gulf War against Iraq and winning congressional approval for the ultimate use of force in January 1991. Robert Bartley is of the opinion that the president might have refused to go along with the tax increases in the 1990 bill if he had not been personally focused elsewhere. A number of antitaxation stalwarts in the congressional Republican delegation, including future Speaker Newt Gingrich, urged him not to support the bill in its final form and themselves voted against it. However, in the wake of Bush’s successful prosecution of the Gulf War in early 1991 and his 85 percent approval ratings in the summer of 1991, objections to the 1990 tax increases were for the most part ignored.

In the Economic Report of the President for 1991, the 1990 law was hailed as a major step toward getting control of the budget. The report focused on how the new law had reformed the budget process. The law slowed the growth of entitlement spending and included a provision
forcing Congress to “pay for” any future expansion in such entitlement spending (or other mandatory spending, such as agriculture programs) with cuts in some other mandatory spending programs. Similarly, any tax cut would have to be paid for by an increase in tax revenues from other sources.9 With the administration basking in the glory of the victory in the Persian Gulf, and with most forecasters believing that the recession of 1990 would be short and shallow, the 1990 budget agreement seemed destined to continue the process of reducing the budget deficit as a percentage of GDP.

Did the Tax Increase Cause the Recession?

Two years later, as the presidential campaign was in the home stretch, there was a great deal of argument suggesting that President Bush’s repudiation of his “no new taxes” pledge had caused the recession. It is certainly possible that the newspaper reports of his willingness to consider tax increases in June 1990 had changed enough expectations in the economy to trigger the recession. However, it appears very unlikely that such talk would have had such a profound impact, especially where there are many more obvious candidates, most notably, the Federal Reserve’s tight-money policy, which slowed economic growth almost to a standstill in 1989.

At the March 1989 Federal Open Market Committee meeting, the approach of this very important body of the Fed was revealed quite clearly. Fear of accelerating inflation dominated the meeting, driving a policy of holding real growth below what was considered the economy’s potential. Pressed by one of the governors as to why such a sustained period of below-potential growth was not expected to have a quicker impact on the rate of inflation, a staff member responded,

MR. PRELL: . . . Let me say first that it takes a period of below potential growth in order for some slack to open up in the labor market in particular . . .
MR. JOHNSON: I know, but there’s a year of that kind of slack . . .
MR. PRELL: But as you know, in our forecast that only brings the unemployment rate up to about 6 percent. The maybe “worst case” interpretation of the events of the last two years is that that’s only getting us back to the natural rate.10

In a nutshell, there you have the focus of the Federal Reserve. While the Reaganites were celebrating the last two of the “seven fat years”
because of the low unemployment and continued growth in per capita GDP, the Federal Reserve staff believed that unemployment had been too low. Staff member Prell stated, “All the anecdotal evidence over the past year or so suggests that in essence we have overshot a level of resource utilization that’s consistent with stable inflation.”\textsuperscript{11} Even though the staff believed that without increasing interest rates, the rate of growth of the economy would slow down and the unemployment rate would edge up, they ended up recommending increases in interest rates in order to head off further rises in the rate of inflation. This was despite the fact that they acknowledged a danger of recession.\textsuperscript{12}

When the members of the committee made their statements, there remained universal fear of further increases in the inflation rate, and explicit rejections of the recession danger. Vice Chairman Corrigan put it that “under the best of circumstances the near-term inflation numbers are going to be bad. And if the economy is simply pausing rather than trending down they could be terrible.”\textsuperscript{13} With only one dissent (Governor Martha Seger), the committee approved the following policy directive.

In the implementation of policy for the immediate future the committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, the developments in foreign exchange markets, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermitting period. The contemplated reserve conditions are expected to be consistent with growth of M\textsubscript{2} and M\textsubscript{3} over the period from March through June at annual rates of about . . . 3 and 5 percent, respectively. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a Federal Funds rate persistently outside a range of 8 to 12 percent.\textsuperscript{14}

In 1988 the rate of growth of real per capita GDP had been 2.8 percent. As a result of the interaction of Federal Reserve policy and general economic trends, it had fallen to 2.4 percent in 1989.\textsuperscript{15}

Investment as a percentage of GDP fell more than one-half of a percent between the second and the third quarter of 1990, over $30 billion.\textsuperscript{16} It is hard to believe that Bush’s statement, coming at the very end of the second quarter, could have such an impact so quickly. When investment decisions change, investment spending changes only after a
significant lag, so even decisions made during early July 1990 would be unlikely to impact the economy in less than three months. Though one might argue about the role of the budget agreement of 1990 in prolonging the recession, it appears to be a very difficult case to suggest that the prediction in June 1990 that there would be such an agreement including a tax increase had precipitated the recession. If anything, the Federal Reserve’s single-minded focus on not permitting inflation to accelerate coupled with the exhaustion of the expansion combined to cause the recession.

Regulation

Reading the reports issued by the Bush administration Councils of Economic Advisers one is struck with the emphasis, over and over again, of the importance of reforming regulation. The 1990 Economic Report focused on environmental regulation, supporting market-oriented solutions over the traditional “command and control” methods of achieving pollution control. In 1991, the report praises the 1990 revision in the Clean Air Act, which incorporated a flexible and innovative market-based system that will secure a substantial and permanent reduction in the sulphur dioxide emissions that cause acid rain. The reduction will be achieved at an estimated cost 20 percent lower than the cost of traditional, less flexible command-and-control regulation.

In the same report, deregulation is celebrated and defended in the areas of energy and telecommunications. In January 1992, President Bush announced a new “regulatory reform initiative.” Its goals were to revise (or repeal where appropriate) those regulations that clearly impose costs that exceed their benefits; ensure that regulatory goals are being achieved at the lowest possible cost; ensure that existing rules rely on market forces rather than command-and-control requirements to the extent feasible; and ensure that regulations provide clarity and certainty to the regulated community and do not promote needless litigation.

The 1992 report devoted a whole chapter to issues in regulatory reform, focusing on the legal system, the environment, natural gas, electric
power, the cable TV industry, and health and safety issues. One proposal resulting from these initiatives, was described in the 1993 report.

[T]he cost to an industrial polluter of reducing emissions by some amount through conventional controls may be $1000, but the owner of an old car that emits the same amount of pollution may be willing to sell the vehicle for $500. Under the EPA’s proposal, the company could purchase the vehicle instead of directly reducing emissions from the plant. . . . The EPA’s “cash for clunkers” program expands the notion of performance standards by permitting standards to be met through alternative means, such as eliminating sources of pollution other than those directly controlled by the polluter.

The report provided a chapter entitled “Markets and Regulatory Reform” that went beyond a discussion of the regulatory-reform initiative and addressed reform of telecommunications regulation, the regulation of banking and finance, and the role of government in reducing environmental and health risks.

In the area of telecommunications, the report recommended removing restrictions on new competition. Interestingly, the recommendations made, even if very general, were all incorporated into the Telecommunications Reform Act passed by the House of Representatives in July 1995. The general approach was that since new technology made dramatic increases in competition possible, regulating rates and enforcing local monopolies (say on local telephone systems or on local cable TV systems) was no longer necessary. Thus, President Bush vetoed the cable TV reregulation act in 1992. Though passed over his veto, this act was repealed in the 1995 House bill.

In the area of banking and finance, the report reached the conclusion that the laws passed in response to the savings and loan crisis (the FDIC Improvement Act and the Financial Institutions Reform, Recovery, and Enforcement Act) “may have created as many new problems as they have solved.” The report actually blamed the law’s stringency for the “shortage of commercial credit during the recent recession and recovery.” The 1993 report reiterated the reform proposals of 1991 that Congress had shown no interest in adopting. The issues that stymied the Congress and the president are similar to the problems involved in reforming telecommunications regulation: (1) How does one get the benefits of increased competition without permitting the rise of giant institutions that can make themselves immune to competition? and (2) How can a particularly crucial industry be pre-
vented from becoming the cause of spreading and dangerous instability without being stifled by regulation?

In the case of dealing with health, safety, and general environmental risks, the 1993 report argued that there had been very significant progress in reducing health and other risks and that government regulations imposed significant costs when they attempted to reduce risks. At one point, the report seems to argue that the market system itself takes care of the problem of extra risks, say on the job, by paying workers “risk premiums” for more dangerous work, thereby creating incentives for businesses to minimize risks. However, the report continues by noting that this works only if workers are fully aware of the risks associated with a particular job, which obviously opens up an important function for government, insuring that all risks are known and publicized. The report does not acknowledge, however, that sometimes workers are stuck in highly risky jobs because they have few alternatives. That fact may seriously reduce the risk premium in their wages. This section of the report is filled with generalities, some of which seem contradictory. For the most part it suggests that modern industrial society has succeeded admirably in reducing risks of all kind, including pollution, with the implication that drastic governmental action to reduce risks is not necessary. Yet many of the examples of reduced pollution and risk are related to the period after 1970, when regulation to control health and safety on the job and air and water pollution were growing dramatically, as Weidenbaum’s data from the 1970s and since clearly shows. The only consistent conclusion one can draw from this section of the report is that regulation had succeeded admirably between, say, 1970 and 1990 and therefore it was no longer necessary, because now all risk reduction was being purchased at too burdensome a cost—all of this, by the way, without quantitative data to relate costs and benefits of existing regulations. There is no question, after reading all the economic reports issued by the Bush Councils of Economic Advisers, that the general thrust of recommendations is in the direction of reducing regulations and changing the regulations that remain so as to use market incentives to achieve the goals of public policy.

The Americans with Disabilities Act

Despite his strong ideological commitment to reducing regulation and some significant practical steps taken in that direction, George Bush’s
The presidency is in fact remembered most for increasing the regulatory burden on American business because he signed the Americans with Disabilities Act in 1990. Just as laws to counter racial and sex discrimination increased the costs of American business, so did this law. The defense of such an act is presented in a very straightforward manner in the 1990 Economic Report.

Inaccessible workplaces and discrimination against disabled individuals have prevented many disabled persons who are able and willing to work from realizing their full economic potential. . . . Survey results . . . indicate that several million disabled individuals who want to work are unable to find employment.

In addition to increasing the likelihood that businesses would utilize the labor of individuals with disabilities, the act also forced institutions such as schools and businesses to alter the delivery of services so they could serve people with disabilities. In some cases, this merely means the installation of ramps so the business is accessible to customers in wheelchairs. In other cases, say a school, it can involve creating modifications in the way courses are taught so as to accommodate students with different kinds of disabilities as well as providing assistance in the form of sign language interpreters (for the hearing impaired) and readers (for the blind).

In order to force institutions to make modifications in their behavior immediately so as to truly open them up to access for all disabled people, this law included something that did not exist in previous civil-rights legislation. Individuals who sued because they had been discriminated against in violation of the act were entitled, if they prevailed, to collect attorney’s fees. With the passage of the Civil Rights Act of 1991, the ADA was amended to include compensatory and punitive damages. This was a very important departure from other civil-rights legislation. Previous efforts to enforce civil rights for, say, ethnic minorities, were usually undertaken only by lawyers who specialized in such law, and in the absence of punitive damages and with the loser-pays provision for attorney’s fees, lawyers could not expect to derive much income from lawsuits. Litigation under the ADA, however, permits attorneys to recover their fees from the loser. This aspect of the law made potential litigation an important club held over the head of businesses and other institutions.

Interestingly, using the threat of litigation to force changes in behavior is consistent with the market-oriented approach to regulation.
of business promoted by both the Reagan and the Bush administrations. The alternative method of enforcing a new civil-rights law like the ADA would be for government to issue direct commands to businesses and other institutions to modify their behavior so as to eliminate discrimination. As time passed, such an approach would produce reams of regulations designed to force business to conform to the spirit of the law. As various *Economic Reports* have pointed out, such an approach increases rigidity and often achieves the positive results sought at great cost.

The method created by the ADA permits private individuals to enforce the spirit of the law by finding other private individuals (lawyers) who are willing to take a chance on earning large fees by winning large settlements in lawsuits. Businesses and other institutions, fearful of such litigation (and perhaps observing some substantial judgments levied against violators of the law) will voluntarily adopt modifications in their behavior in order to insulate themselves from the danger of litigation. For many who believe in the role of the free market in enforcing behavior that the consumers and other participants desire, litigation and the danger of litigation is far preferable to government setting and enforcing the rules of conduct.

Paradoxically, in apparent contradiction to the reliance on the impact of litigation, an effort known as “tort reform” was under way that attempted to limit the amounts of punitive damages and attorneys fees that can be recovered as a result of injury, say from a defective product or because an institution violated someone’s civil rights. The Bush administration proposed an Agenda for Civil Justice Reform in 1991 that was summarized in the 1993 *Report* as follows:

- capping punitive damages at an amount equal to a plaintiff’s actual damages

- discouraging frivolous suits by adopting, in a limited set of Federal cases, a modified “English rule” in which the loser would pay the winner’s legal expenses, up to a level equal to the loser’s expenses;

- limiting the amount of free document requests, after which the requestor would have to pay the costs of providing the documents.28

The 1991 Civil Rights Act itself specifically limited punitive damages to three hundred thousand dollars for the largest business firms and fifty thousand dollars for firms with one hundred employees or less.29 However, compared to previous civil-rights legislation, the exis-
tence of punitive damages coupled with the ability to recover attorneys' fees made it likely that the passage of the ADA would lead to a big increase in litigation.\textsuperscript{30}

Since the ADA is still a relatively recent act, there have been no national studies of its impact on business expenses. Nevertheless, we can assume that it imposes two sets of costs on American businesses. The first set involves one-time changes in personnel policies based on studying the ADA, altering job descriptions, and educating all decision makers in the organization about the behavior required by the ADA. These costs are significant, but once changes are in place, there is little ongoing expense other than monitoring within the organization to make sure the new way of doing things is actually carried out. This suggests that the Equal Employment Opportunity Commission was correct in predicting that the regulations issued to implement the ADA “will not have a significant economic impact on a substantial number of small business entities . . . based upon exiting data on the costs of reasonable accommodation.”\textsuperscript{31}

The second cost is imposed on places of public accommodation. It involves adjusting their delivery of service to accommodate consumers with disabilities. Take the case of colleges and universities. Here, the expenses involve some changes in the physical facilities in order to accommodate people with disabilities and reasonable accommodations in the programs offered so that students with physical and/or mental disabilities will be able to “consume” them. In a program presented by a consulting group to the College and University Personnel Association in April 1992, the administrators were admonished that the ADA required

- Providing assistance to disabled students or members of the public in order to provide them access to all services offered by the university;
- Eliminating discriminatory criteria on who can receive services, and practices that tend to screen out or adversely affect disabled persons;
- and Providing special equipment or services to persons with disabilities on request, when needed to allow them to use all of the services of the college on an equal basis.\textsuperscript{32}

These requirements have caused colleges to hire sign-language interpreters for hearing-impaired students and to provide reading machines
for vision-impaired students. According to the report, individuals offered these accommodations cannot be charged for them.

Another accommodation involves adjusting instruction in order to accommodate students with learning disabilities. Under the ADA, students applying for admission may not be rejected solely on the basis of any disability, including a learning disability. Once a student is admitted, a school must make “reasonable accommodation” for such students. This does not mean providing special classes and special support, as in special-education programs in public high schools. It does, however, mean making certain changes in how courses are delivered, such as permitting some students untimed testing. Many colleges are now creating an Office of Disabilities Services and are attempting to codify the various modifications that they believe the ADA will require them to make. This process is ongoing and at times involves delicate negotiations with professors about the methods of instruction and evaluation in their classes. Should individual faculty fail to make the adjustments deemed necessary and appropriate, the institution could be faced with a lawsuit from an already admitted learning-disabled student. At the very least, then, institutions are having to spend some resources in an ongoing program of accommodating students with learning and physical disabilities.

Title IV of the ADA applies to newly constructed facilities. It does not require complete retrofitting of existing facilities but does require that any changes made include improvements to make the facilities accessible to people with disabilities. On colleges and university campuses, this involves not merely making sure all buildings are accessible to the physically handicapped but also that connecting paths between buildings are similarly passable.

These costs of compliance are real, though as yet unquantifiable. Perhaps more significant have been litigation costs, which are likely to be substantial. However, just as in the case of fighting racial and gender discrimination, the end result of the changes envisioned by the ADA would be of great benefit to the entire society. A whole group of citizens, previously kept from utilizing their full productive capacity in the marketplace, now are adding to the society’s GDP to the best of their abilities. Others with the same disabilities are fully participating as consumers in the marketplace for goods and services. The extra costs imposed on business, many of which are merely once-for-all transition costs, including the litigation costs that will establish important precedents, are more than compensated by the benefits to the entire
society from expanding the scope of competition for jobs as well as increasing the size of the market for all products. The problem is that the benefits take time to appear, while the costs are felt immediately. In addition, the costs impact on specific businesses, while the benefits appear to accrue only to the disabled.

In fact, just as the reduction in racial discrimination benefited the entire society, not just ethnic minorities, there are benefits diffused throughout society that result from the more inclusive economy mandated by the Americans with Disabilities Act. On balance, the benefits of this law far outweigh the costs, but as the costs are real, it would not be surprising if many businesses and other institutions felt put upon by its passage and the new regulations issued by the Equal Employment Opportunities Commission. The same goes for the rising litigation costs of honest institutions attempting to comply with the law.

**Civil Rights**

In the area of civil-rights enforcement, the Bush administration, for all its intentions to limit the role of government in regulating business, found itself supporting a new civil-rights act that overturned a Supreme Court ruling that had reduced the burden of complying with previous civil-rights statutes. Up until 1989, the Civil Rights Act of 1964 had been interpreted by the Supreme Court as forbidding not only unfair treatment of individuals as a result of race, sex, or national origin, but practices that disproportionately burdened racial and ethnic minorities or women unless such practices could be shown genuinely to assess candidates’ suitability for the job in question.33

Recall our discussion of affirmative action in chapter 5. If a device by which employers screen candidates has a disproportionate impact on racial or ethnic minorities or women and has no direct relationship to the requirements of a job (for example, requiring that candidates for an executive position be able to bench-press two hundred pounds would not identify an ability needed for the position and would discriminate against women), it is evidence of discrimination.

In 1989, the Supreme Court in *Wards Cove* overruled the prevailing precedent and held that the burden of proof now was, not on businesses to show that policies were necessary, but on the individual alleg-
ing discrimination to show they were unnecessary. Just this shift in the burden of proof removed a substantial expense from businesses. But it was seen by many in the civil-rights community as a step back from the policies that had been in place at least since 1971, when the original Supreme Court precedent was set.\textsuperscript{34}

The result was that Congress passed legislation to reverse the Supreme Court decision. It could do so because the Court was interpreting certain sections of the Civil Rights Act of 1964, not declaring any part of that act unconstitutional. However, the first attempt by Congress was met by a veto from President Bush, who claimed that redirecting the burden of proof to businesses would induce them to adopt a system of hiring quotas to make them lawsuit-proof. Only after the bruising Clarence Thomas Supreme Court confirmation fight in 1991 did President Bush sign a modified version of the original bill.\textsuperscript{35} Many in the business community saw no difference between the bill the president signed and the one he had vetoed in 1990. In their view, an effort to reduce a burden on business imposed by civil-rights legislation and previous legal precedent had briefly borne fruit with the Supreme Court decision of 1989 only to be rolled back when Bush caved in to the majority in Congress.

The Bush administration also presided over other significant expansion in the federal regulatory apparatus. If we assume that the $9.74 billion regulatory budget from 1989 was a holdover from Reagan, the four Bush years saw a 19.6 percent increase through fiscal 1993.\textsuperscript{36} Melinda Warren of the Center for the Study of American Business noted that “since President Bush took office, the regulatory machine has grown considerably, but at a slower rate than in the last few years of the Reagan administration”\textsuperscript{37}—another example of a “half full/half empty” dilemma. This raises the question of whether the Bush administration was improving upon the Reagan record or continuing a trend reversing the successes from Reagan’s first term. If we follow the rule of thumb and multiply the explicit costs of regulation by twenty, the indirect impact of these increases was dramatic. And note, this is before the implications of the ADA had begun to be felt.

**The Failed Recovery of 1991–92**

If the increased cost of regulation and the violation of the “no new taxes” pledge created disaffection among some Republicans, the per-
ceived failure of the Bush administration to create a strong recovery from the 1990 recession undoubtedly was the main reason for the defection of the so-called Reagan Democrats from the Republican Party in the presidential election of 1992.\textsuperscript{38} Just as during the election of 1982 there was a significant falloff in support for President Reagan that led to large Democratic gains in the midterm congressional elections, in 1992, the slow pace of the recovery coupled with rising unemployment led to a tremendous reversal of fortune for President Bush.

With his popularity at an almost unbelievable 85 percent in the wake of the victory in the Gulf War, many of the so-called heavy hitters among Democratic politicians (Governor Mario Cuomo of New York, Senator Bill Bradley of New Jersey, Senator Edward Kennedy of Massachusetts, Representative Richard Gebhardt of Missouri) declined to enter the presidential sweepstakes. It was left to an obscure governor from Arkansas whose only previous national exposure had been an interminable nominating speech at the 1988 Democratic convention to become the “front-runner” as 1991 drew to a close.

But something extraordinary happened between the spring of 1991 and January 1992. The recovery that the National Bureau of Economic Research dated from the first quarter of 1991 did not translate into reduced unemployment and rising incomes. For the first time in all postwar recoveries, a full two years after the recovery began the unemployment rate was \textit{higher} than when the recession presumably ended. The Bush administration and the Federal Reserve had been quite optimistic that the recession that began in the third quarter of 1990 would be short and shallow, ending with the “soft landing” that had eluded the Carter administration in 1979 and that the Federal Reserve had attempted to orchestrate in 1988 and 1989. They predicted that the rate of growth of real GDP would be 0.9 percent from the end of 1990 to the end of 1991, three times as fast as the rate of growth in the previous year. They also predicted that growth would be “robust” in 1992: “Business investment and construction activity are expected to be especially strong.”\textsuperscript{39} As a result of this optimism, there was no fiscal initiative to fight the recession in all of 1991. Meanwhile, the Federal Reserve permitted the Federal Funds rate to fall less than 1 percent over the first three quarters of 1991, and the prime rate fell less than 1 percent in the same period.

By the fourth quarter of 1991, the recovery that was dated from March of that year had seen none of the acceleration that the economy experienced in 1983 and 1976, for example.\textsuperscript{40} The rate of growth of real
GDP from the first quarter of 1991 to the first quarter of 1992 ended up being 2.1 percent.\textsuperscript{41} In per capita terms, the real GDP rose only 1 percent from the first quarter of 1991 to the beginning of 1992.\textsuperscript{42} As mentioned above, the unemployment rate kept rising even though the recovery had begun. By the end of 1991, President Bush was in trouble, and the reason was the economy.

The Federal Reserve redoubled its efforts to ease monetary policy. The Federal Funds rate fell more between the third and fourth quarters of 1991 than in the previous three quarters combined.\textsuperscript{43} This expansionary monetary policy continued throughout 1992 and 1993 as well. When interest rates finally stopped falling, the Federal Funds rate had fallen from 8.29 percent in June 1990 to 2.96 percent in December 1993, a decline of 64 percent.\textsuperscript{44}

Belatedly, in January 1992, the Bush administration attempted to interject some fiscal stimulus into the economy. The major change that could be accomplished without the help of Congress was changing the rate of withholding on the personal income tax. In general, unless taxpayers make specific requests, the rate at which federal income taxes are withheld from salaries and wages is such that most taxpayers would be entitled to some refund when the time comes for final reconciliation. During the 1980s, approximately three-quarters of all taxpayers filed for refunds. The Bush administration hoped to increase spending by taxpayers as a result of this reduction because people received higher amounts of take-home pay. Of course, any increase in aggregate demand caused by this shift would be exactly balanced after April 15, 1993, when the extra amount not withheld would cause lower refunds. Nevertheless, increased spending in early 1992 might increase the optimism of businesses, which would then expand production and hire more people, and the recovery would begin in earnest. However, the result of the administration’s effort was undetectable. The ratio of consumption to personal income was no higher in 1992 than in 1991. By contrast, the percent of personal income devoted to consumption rose more than 2.5 percentage points between 1982 and 1983 and rose 1.4 percentage points between 1974 and 1975. Both of these increases can be attributed to tax cuts that took effect in those years.\textsuperscript{45}

Meanwhile, the actual (total government) deficit as a percentage of GDP only went up from 2.4 in the first quarter of 1991 to 4.5 in the third quarter of 1992. One area where the Bush administration departed from the approach of its predecessor was in extending unemployment compensation benefits.\textsuperscript{46} Initially, in the early months of the
recession, the Bush administration made no moves to extend benefits, and the first years after the downturn began saw no higher a percentage of the unemployed collecting benefits than in the first two years after the 1981–82 recession began. But during 1992, as a result of the laws passed in 1991, the percentage of the unemployed collecting compensation payments rose to 56 percent, fully 10 percent more than in the previous recession and in the early months of the recovery.47

In addition, the liberalization of access to welfare, food stamps, and Medicaid led to a virtual explosion of expenditures in these areas. Medicaid expenditures grew at the rate of 9.9 percent between 1983 and 1987, 13.7 percent between 1987 and 1990, and a whopping 28.1 percent between 1990 and 1992.48 AFDC expenditures had grown only 1.3 percent between 1980 and 1990, but between 1990 and 1992 that growth was 11.7 percent.49 Food stamps had grown on an average of 1.9 percent per year between 1980 and 1990, but between 1990 and 1992 that average rose to 17.2 percent a year.50 Finally, SSI had increased on average 3.2 percent per year between 1980 and 1990, but between 1990 and 1992, the increase was 12.5 percent per year.51

It all begins with jobs. From the nadir of 1975, the economy created over six million jobs in the next two years. From the nadir of 1982, the economy created over five million jobs in the next two years. In the 1990 recession, the falloff in employment continued into 1991, and over the next two years fewer than three million jobs were created.52 As the State of Working America pointed out, most of the jobs created during the recovery were low wage. One of the causes was declining defense spending. After reaching a peak as a percentage of GDP in fiscal 1986 (6.3 percent), defense spending slowed between fiscal 1987 and fiscal 1990 from 6.1 percent to 5.3 percent. Beginning in fiscal 1990, in recognition of the end of the Cold War, absolute dollars spent on defense began to decline, accelerating the fall as a percentage of GDP.53 Though this decline reduced the federal budget deficit in the years after 1990, it made it harder for the economy to generate a good head of steam for the recovery. Equally important, employment in defense contractors also fell, with states like Connecticut and California experiencing much worse recessions than other parts of the country.

With few jobs created and good jobs in defense-related industries being lost, it is not surprising that the percentage of the population qualifying for food stamps and Medicaid would increase. Even with the efforts of some states to develop welfare to work programs pursuant to the Family Support Act of 1988, AFDC rolls increased rapidly.
as well. In just two years between 1990 and 1992, the number of families receiving AFDC rose from 4 million to 4.8 million, almost 2 million additional recipients.\textsuperscript{54} One aspect of the Family Support Act that contributed to an increase in AFDC enrollment was the requirement that states offer an AFDC program to intact two-parent families in which the breadwinner was unemployed. Though numerically small relative to the traditional AFDC family (single parent with children), enrollment in this program (called AFDC-UP for “unemployed parent”) rose 26 percent between 1990 and 1992 a direct result of the combination of the recession and the Family Support Act.\textsuperscript{55}

While increased spending on Medicaid could in part be blamed on general inflation of medical costs, we should recall the significant liberalization of eligibility during the second half of the 1980s.\textsuperscript{56} In Medicaid financing of nursing care, the cost per recipient rose quite rapidly between 1990 and 1992, partially as a result of the mandate to states imposed by the Budget Act of 1987 to increase the quality of care delivered. Higher-quality care meant higher prices, which meant higher costs to the states. The states, in turn, petitioned the Health Care Financing Administration for increased federal funds.\textsuperscript{57}

The interaction of recession, slow job growth, and slow income growth in the period from 1989 through 1995 is very significant when we contemplate ways to solve the problems associated with public assistance. According to the proponents of the recently enacted welfare reform legislation, the main problem with the economy is the unwillingness of individuals to work. Forgetting for the moment that many of the people receiving food stamps and Medicaid are also working, note that if the explosion in the costs of means-tested entitlements after 1990 was caused by unwillingness to work, this unwillingness had arrived very suddenly. Just three years earlier, when the economy had not yet slipped into a recession, the costs of all these entitlements were growing much more slowly and the percentages of the population receiving them had not changed much since the previous recession. The timing and the speed with which the percentages of the population receiving these programs increased should suggest that something as basic as the “character” of the individuals receiving these transfers could not have caused such a significant shift. However, the cumulative impact of slowly growing incomes at the bottom of the income distribution over the entire decade and the increase in unemployment during and after the recession can explain these increases. It wasn’t the people
who had suddenly failed by revealing a terrible character defect. It was
the economy that failed the people.

**Enter H. Ross Perot**

H. Ross Perot focused most of his on-again, off-again presidential
campaign on the problem of the economy, exemplified, he argued, by
the ballooning of our national debt during the twelve years of the Rea-
gan-Bush administrations. As noted earlier, his rhetoric and published
analyses argued that “Our first priority is to balance the budget.”
Without discussing how the budget deficit and the national debt have
caused the decline in productivity growth, the recession, and the slow-
down in overall economic growth, he asserted the connection. Many
of his proposals in the presidential campaign; in his first book, _United
We Stand_; and in _Not for Sale at Any Price_, which he wrote in 1993 are
related to the need to eliminate the deficit and then begin to pay down
the debt. Some of his other proposals, to improve education, to stim-
ulate investment, to fight poverty actually require reductions in rev-
ue (as a result of tax credits) or increases in spending. He denies that
any of his proposals require spending increases—in effect, better lead-
ership and organization will create more efficient delivery of services
such as education and health care. However, he does explicitly recom-
mand tax credits for a number of goals and that clearly reduces gov-
ernment revenue.

The point of this is not to belabor the specifics of Ross Perot’s pro-
gram. What is important is that with his third-party candidacy for
president in 1992 and his subsequent activities on the political front he
put the problem of the budget deficit and the national debt at the cen-
ter of the political debate. He also validated the criticisms made by
Democratic nominee Bill Clinton of “trickle-down economics.” Since
the economy was not rolling along as it had been in 1984 and 1988, it
was impossible for the incumbent president to ignore the complaints
about the deficit. Instead, President Bush was left defending his record
by apologizing for signing the 1990 tax bill and promising never to do
it again, while warning that if the Democratic candidate, Bill Clinton,
were elected he would raise taxes even more. He also argued in vain
that the economy was well on its way to recovery. Interestingly
enough, the fourth quarter of 1992 saw the first dip in unemployment
and a significant increase in the rate of growth of real per capita GDP. Unfortunately, these numbers came too late to help the president’s reelection effort.

Meanwhile, commentators and others got into the act by focusing on Perot’s proposals to raise taxes and cut the growth of entitlement programs.\(^{62}\) This caused those who were not persuaded that the deficit was as dire a danger as Perot asserted to become fearful of the impact of a Perot deficit-reduction policy. Into this campaign stepped Bill Clinton. Emerging from the Democratic primaries with an insurmountable lead to win a nomination that most people thought would be a worthless prize just six months earlier, he discovered to his surprise that his message resonated in the country. He promised to get the economy moving again while making a strong effort to rein in the budget deficit. Though much attention was given to his promise of a “middle-class tax cut,” he also promised to raise taxes on the wealthy who had benefited disproportionately from the years of Reagonomics. He also explicitly promised to use government spending to invest in education and infrastructure. President Bush’s warnings that Bill Clinton was a “tax-and-spend Democrat” attempting to cloak his policy predilections with new rhetoric about “fairness” and “investment” could not overcome the disgust people felt with the failure of the economy to rebound from the recession.

One interesting area where Clinton did not join Perot in his criticisms of the Bush administration was in the area of trade agreements. While criticizing the Bush administration for not defending American interests against “unfair” Japanese competition, candidate Clinton supported the ratification of the North American Free Trade Agreement. In a sop to his labor and environmentalist supporters, Clinton promised that before submitting it to Congress for ratification he would negotiate some side agreements with Mexico so that labor rights would be protected and environmental laws would be enforced. He argued that without such agreements, the reduction of tariffs on imports from Mexico would permit Mexican industries (often American firms producing in Mexico) to cut costs and undersell American producers because they are ignoring Mexican environmental laws and underpaying Mexican workers. Perot, on the other hand, warned that if NAFTA were passed there would be a “great sucking sound” as American jobs vanished over the Rio Grande with American firms setting up plants just on the Mexican side employing cheap Mexican labor. Though the majority of Clinton’s supporters probably opposed
the ratification of NAFTA, it was not a major issue in the campaign once Clinton agreed to support it.

With Perot taking 19 percent of the popular vote, and drawing most of those voters from President Bush, Clinton was elected with only 43 percent of the popular vote but a commanding lead in the electoral college. He took office promising to “focus like a laser” on the problems of the economy. He also promised to propose a comprehensive reform of our health care system. In an economic-policy conference held in December 1992, he strenuously argued that it would be impossible in the long run to reduce the federal deficit if health care costs were not contained. The economy and health care, thus, were the major issues on the agenda as he took office in January 1993.

The 1993–94 Clinton Program: Attempted Reversal

When Bill Clinton was running for the White House, the “war room” of his campaign in Arkansas reportedly sported a big sign, “It’s the economy, stupid!”63 The point of course was that the economy was the major issue in the campaign. In a sense, though he didn’t use the rhetoric, he was running the same kind of campaign that Ronald Reagan had run in 1980. Then, Reagan had asked the question, “Are you better off now than you were four years ago?” Just as many Americans responded to that earlier question by voting to throw President Carter out of office, there were an even greater number of Americans (62 percent of the popular vote) who voted to deny President Bush a second term because of his perceived failings in economic policy.

Reagan introduced his program for economic recovery early in his presidency. Following the same procedures, President Clinton presented his program in February 1993. He called it A Vision of Change for America. The change he contemplated was to correct the economic failures of the twelve years of the Reagan and Bush administrations. The failures he enumerated were (1) the anemic nature of the economic recovery from the 1990 recession, (2) stagnation in the standard of living for the majority of the population since the early 1970s, (3) increased income inequality and the shrinkage of the middle class, (4) the run-up of the national debt through the massive deficit spending during the previous twelve years, and (5) failure to use the borrowed funds productively during that same period, more specifically the neglect of infrastructure and education. Clinton’s program attempted
to deal with all of these problems at once, and he promised more long-
term solutions to other problems such as health care access and costs
and the need to reform the welfare system.64

1. In order to accelerate the recovery that had been so disap-
pointing up to the end of 1992, he proposed what was called a “stimu-
lus package.” This involved spending increases on various government
projects, mostly having to do with infrastructure investment and job
creation. It also involved some targeted tax credits to encourage pri-
vate investment. Finally, it extended unemployment benefits to cope
with the fact that unemployment kept rising for most of 1992 even
though the recession was supposed to be over. This fiscal stimulus to
the economy was to total $30 billion in spending and tax cuts and to
occur during the fiscal year that had already begun, 1993 as well as
1994.65

2. To raise the incomes of the majority of the population, it was
essential to move toward full employment and even more important to
make sure that the jobs people obtained were well-paid jobs. This
required education and training for young people and workers. Such
expenditures were the kinds of “investments” in people he talked about
during his campaign, but given the necessity of reducing the budget
deficit, very little could be attempted in this area early on. Neverthe-
less, his program did include a few proposals with these long-run goals
in sight.66

3. The reduction in inequality was to be accomplished via certain
tax changes. During the campaign he had promised to reverse the Rea-
gan tax approach by raising taxes on the wealthy and giving the middle
class a tax cut. Though the specifically middle-class tax cut was aban-
doned, he did propose increased taxation on the well-to-do and a tax
cut and wage subsidy for lower-income workers via a substantial
expansion of the earned-income tax credit. As mentioned above, the
EITC provided for reduced taxes (and if the credit exceeded the tax lia-
ability a direct payment) for individuals who worked and had at least
one dependent child. When fully phased in, this expansion led to a tax
cut for every wage earner, even one without children, who earned less
than thirty thousand dollars a year. The middle class with incomes
higher than this received no tax cut. Meanwhile, Clinton proposed
increasing the top marginal income tax rate from 31 percent to 36 per-
cent, with a 10 percent surcharge on top of that for taxpayers with
greater than $250,000 of taxable income.67 He also proposed raising
the percentage of Social Security payments subject to taxes for retired
couples with more than thirty-two thousand dollars of income. Together, these changes did increase the tax burden on the top 20 percent of taxpayers.

Interestingly, the other sources of inequality identified in chapter 9 were presumably going to be reversed by increased training so that more working people could work at higher-paying jobs. Many people dubbed this the “field of dreams” version of good jobs, after the movie in which a man builds a baseball diamond on his farm and the stars of yesteryear appear in this field. Many doubted that creating more trained people would automatically attract the good jobs for which they were qualified, but the approach Robert Reich, whom Clinton named his secretary of labor, developed in *The Work of Nations* was that businesses have the whole world before them when they consider where to locate their operations. They will build the facilities that require highly skilled people where those people are. If we train the people, the argument goes, the jobs will come.

One other element of this approach was the firm Clinton administration commitment to free trade. In exchange for opening up the United States to imports that might tend to substitute for mass-produced products that employ semiskilled blue-collar workers, American businesses would receive access to foreign markets for more technology-intensive products, creating demand for more highly skilled workers. Thus, for example, the argument over NAFTA, though often conducted as if it were an argument about how many jobs on balance would be created or lost, really was about the quality of the jobs created as opposed to the quality of the jobs lost.

4. Even before he became president, Clinton was made aware that his most important priority was to “impress the financial markets” that he was serious about reducing the federal budget deficit. Journalist Bob Woodward describes a meeting between President-elect Clinton and the chairman of the Federal Reserve Board, Alan Greenspan, in December 1992. According to Woodward, Greenspan’s main point to Clinton was that reducing the long-term interest rate was the best method of increasing economic growth. Unlike the Federal Funds rate (and other short-term rates), which were amenable to Federal Reserve control, long-term rates reflected the various financial-market fears of future inflation. Because deficits in the 1960s had produced double-digit inflation in the 1970s, investors feared that the increased deficits since 1990 (and for the foreseeable future) would translate into inflation sooner or later and thus were demanding a higher inflation
premium than in previous decades. According to Greenspan, the only way to get long-term interest rates to come down would be to enact a *credible* deficit reduction program.68

Notice how many controversial assertions are packed into this argument. First of all, deficits in the 1960s are dubious candidates for the main cause of the inflations of the 1970s. Oil price increases, dollar depreciation, and the short-term experience with price controls all played a major role in ratcheting up inflation between 1972 and 1974.69 The 1979 inflationary surge followed two years of rather substantial deficits in 1975 and 1976, but during most of 1978 and 1979, the total government budget was actually in surplus.70

The spread between long-term interest rates and the Federal Funds rate had indeed reached unprecedented levels in 1992. Using the thirty-year Treasury bond as the example of a long-term interest rate, the gap had been in the 3 percent range during 1985, but in 1992 the gap had gone above 4 percent. However, in real terms, both the Federal Funds rate and the thirty-year rate had been higher in 1984–85 than in 1992.71 Thus, the difference was not caused by the inflation premium that bondholders were insisting on before purchasing long-term debt instruments. Instead, the cause of the smaller spread in the 1980s (which actually turned negative in 1989) was the tight money policy of the Fed in the period after 1984 that kept the federal funds rate from falling as much as the long-term rate. By 1992, in contrast, the Federal Reserve was pursuing an expansionary monetary policy. The spread and both real interest rates fell over the later years of the 1980s despite the persistence of high structural deficits. With the sluggish recovery from the 1990 recession, the spread once again opened wider than in the past, even though the absolute level of the real interest rates remained lower than in the middle 1980s.72

Greenspan was arguing that a credible deficit reduction plan would reduce long-term rates, but in fact the 1990 budget agreement had been such a credible plan. It had failed to reduce the actual deficit because of the recession. What Greenspan didn’t tell Clinton was that if his deficit reduction plan aborted the recovery and brought on a recession, the gap would stay wide, because the deficit would balloon again. Instead, Greenspan stressed that deficit reduction would cause the rates to come down and stimulate the economy. In other words, Greenspan was predicting that the only thing holding up private investments was high interest rates, and that lower long-term rates would be sufficient. Again,
there is tremendous disagreement among economists as to how interest-sensitive investment decisions actually are.

5. Clinton responded by attempting to make deficit reduction and his investments (infrastructure, training, tax-based incentives) central to his plan. *A Vision of Change for America* included lots of details on specific kinds of investments as well as spending cuts aimed at deficit reduction.

**Clinton’s First-Year Program: An Assessment**

In theory it would have been possible for most of these goals to coexist in the same package. Deficit reduction could occur with reductions in overall spending and increases in taxes on balance. Within the federal budget, however, spending could shift toward investments such as infrastructure and education and away from less productive activities, particularly defense. On the revenue side, the tax increases could be placed on well-off taxpayers and some of the middle class, and others could actually get some tax relief. Unfortunately, to accomplish both of these tasks would have required deep cuts in defense spending and steep increases in the tax burden of the well-off. Since the defense budget was already being cut according to a schedule designed by the Bush administration after the demise of the Soviet Union, and since those cuts were already producing significant layoffs within defense industries with important consequences for some states and localities, it is hard to imagine that speeding up those cuts or making them even deeper would have been politically feasible.

And regardless of the possibility of reconciling the policies of deficit reduction, middle-class tax relief, and increased public investment, it was impossible to reconcile deficit reduction and “stimulus.” In fact this same problem confronted the Reagan administration and Paul Volcker in 1981. Volcker was jamming on the brakes with tight monetary policy in order to fight inflation while Reagan’s tax cuts aimed at stimulating incentives were pressing on the gas, raising aggregate demand. Until Volcker’s Fed ended the monetarist experiment and eased up on monetary policy, the brake pedal held and the economy experienced a long, wrenching recession. Clinton tried to finesse the contradiction by the timing of the stimulus package. According to *A Vision of Change for America*, in 1993 the stimulus package would
temporarily increase the deficit. Beginning in 1994 the deficit reduction changes voted in 1993 would take over, and there would, in fact, be no more fiscal stimulus emanating from the federal budget. The hope was that the short-run stimulus of 1993 would accelerate the recovery, leading to rising consumer spending. When the drag of decreased deficit spending occurred in 1994, private-sector investment spending would be expanding to take up the slack, both in response to that rising consumer spending and in response to the fall in long-term interest rates predicted by Alan Greenspan (and many others as well). Notice that this is very similar to the hope of the Bush administration that merely changing the timing of income tax collections in 1992 would provide a strategic push to aggregate demand.

Again, regardless of the potential rationality of such an expand-then-contract fiscal policy, the presumed need to reduce the deficit led many to question the economic rationality of attempting to stimulate the economy. How can you do something and its opposite at the same time? This problem was not lost on President Clinton, who himself observed that his administration was trying to stimulate the economy and reduce the budget deficit at the same time, something that had never been done before!

The importance of the stimulus package went beyond increasing aggregate demand. Candidate Clinton had made it abundantly clear that he was not merely criticizing the size and growth of the budget deficit, he was also arguing that the money borrowed by the federal government had not been invested productively. He implied that if less had been used to fund tax cuts and some of the defense buildup, it could have gone toward infrastructure investment and education reform. Here he was echoing Reich, who had argued that the key to the economic growth of a particular nation in the global marketplace was to have the infrastructure and the skilled, educated population that international corporations wanted. The government ought to be spending money on such items, according to candidate Clinton, and the Reagan and Bush administrations had seriously neglected such responsibilities.

His administration wanted to make a clean break with the Reagan-era conventional wisdom that all government spending is wasteful. We noted in chapter 1 that economic growth requires significant government assistance, if only in the education of the labor force. Later we noted the role of certain essential public works summarized under the heading infrastructure. Following on the campaign theme, many in the
Clinton administration were anxious to begin at least token investments as part of the stimulus package, even though the quantitative impact would be minor, if visible at all. In the words of one of his aides, quoted by Woodward, the stimulus package was not economic policy but social policy.

In addition, the administration feared that the recovery had been so lackluster that any move toward fiscal restraint associated with a significant deficit reduction package would stop it in its tracks and create a new recession. Aside from the political and economic damage a recession would do, it would also make deficit reduction virtually impossible, as in the post-1990 period.

This two-part program was introduced into Congress as two separate bills, one for the stimulus package and one as the Omnibus Budget Reconciliation Act of 1993. The latter made good on the Clinton campaign promise to introduce a serious deficit reduction package and to include in it income tax increases on those with high incomes. However, President Clinton had to apologize on national television for being unable to recommend a middle-class tax cut, such as he had promised in the campaign, because the deficit was much higher than he had thought during the campaign it would be. This latter point was probably more wishful thinking than accurate reflection of the information available in the fall of 1992, and many people just shrugged it off as just one more politician’s lie. Only lower-income taxpayers received a tax cut through the expansion of the earned-income tax credit.

The vehicle chosen to raise a significant amount of revenue as part of the deficit reduction was a tax on business use of energy, called the BTU tax. BTUs (British thermal units) measure quantities of energy. As opposed to a broad-based sales tax, this tax was considered a useful inducement to increased energy efficiency and reduced pollution. Businesses that used energy more efficiently would have less of a tax burden, and there was hope that businesses would begin to switch to more energy-efficient methods. Though not exactly the same, this tax was analogous to one that had been proposed by environmentally conscious economists for many years, the so-called carbon tax. Under a carbon tax, each production and consumption activity would be taxed according to the amount of carbon released into the atmosphere as a result. The idea was to put pressure on businesses and consumers to reduce the release of carbon, a major cause, it was argued, of global warming. Though the BTU tax did not target carbon specifically, by
working to reduce consumption of fossil fuels, it would have an indirect effect of slowing the release of carbon into the atmosphere.

It is interesting that from the point of view of supply-side economics, this proposal is clearly superior to a progressive income tax. First of all, the marginal tax rate for an increase in income is zero under any tax on consumption, whether computed on the value of sales (as in most states), on the amount of fossil energy consumed by a product, or on any other form of consumption spending. Second of all, taxing these energy products would fulfill one important role of government developed in chapter 3, adjusting the composition of output to take account of social costs and benefits. Third, since the tax was on consumption, it should have some (probably small) positive impact on savings compared to an income tax that raised the same amount of revenue.

For all of these reasons, if the proposal had not come from a Democratic president, many conservative economists and politicians would probably have supported it. Conversely, if the proposal had come from a Republican president, few liberal Democrats would be willing to support it because as with all consumption taxation, the impact would be felt most by low-income people. The liberal Democratic approach is that the best way to raise revenue is through progressive income taxation that starts with a zero rate on low-income people. The Clinton proposal shows how far the debate had been shifted since the late 1970s. Returning to the progressive income tax rates of the pre-1980 period (see table 4) was clearly out of the question. In order to raise the revenue needed to create a credible deficit reduction program, a broad-based consumption tax was a necessity, even if it violated the equity principles Clinton was trying to reestablish with the increase in taxes on higher-income taxpayers and the expansion of the earned-income tax credit.

The Republicans refused to support the BTU tax because they were united behind the principle that all deficit reduction should come from spending cuts rather than tax increases. While this argument can make sense if one is adhering strictly to a supply-side argument about incentives and the tax in question raises marginal tax rates, it makes no sense whatsoever when one is talking about a consumption tax. In one aspect of the Clinton proposal, the argument that spending cuts are superior to tax increases reached absurd lengths. Recall that as part of the Social Security reform in 1983, Ronald Reagan had been persuaded to support the taxation of half of Social Security benefits for high-
income recipients. The reasoning used by those who persuaded him was that it was not a tax increase but a net reduction in benefits. In fact, from that point onward, the Reagan administration had listed all income tax revenue collected from Social Security recipients as a spending reduction, not as a tax increase.

When the Clinton administration released its list of proposed spending cuts and tax increases, it followed the same (misleading) method and listed the increased revenue from expanded Social Security income taxation in the column of spending cuts. This brought howls of protest from those who had insisted spending cuts predominate over tax increases. The reason this whole discussion is ludicrous was spelled out clearly by economist Robert Eisner.

Suppose social security benefit payments were reduced at the source by an amount corresponding to what would otherwise be taken away in taxes, probably by withholding, so that the checks would be the same. Would the amount spent by retirees be different? We might add a further question: would the incentives of retirees be any different? So aside from the need to score points against your political opponent, does taxing Social Security benefits differ in any meaningful way from reducing Social Security benefits for the same people the same amount?

Whatever the theoretical reasons for reducing the deficit using a BTU tax, in political terms this tax became a very hard sell. After passing the House, it was dropped from the Senate version of the deficit reduction plan in favor of adding a few cents per gallon to the gasoline tax. Meanwhile, just as the Republicans did not discriminate when it came to taxes (they were opposed to all of them), they did the same with the investments Clinton was trying to push with his stimulus package. A Republican filibuster blocked it in the Senate, and the administration gave up on it in April.

With that, the Clinton administration was left with only one economic strategy, deficit reduction. With the most extraordinary effort, over unanimous Republican opposition and with grudging support from many Democrats, the Omnibus Budget Reconciliation Act of 1993 squeaked through without a vote to spare. The deficit reduction actually accomplished by the act was only $3 billion less than the $148 billion reduction projected in *A Vision of Change for America*. The projected deficit reduction for 1998, compared to what would have occurred with no policy change, in OBRA 1993 was almost the same as
called for in *Vision of Change*, even though the stimulus package had been abandoned.\textsuperscript{75}

This victory actually masked the important fact that the Reagan Revolution had succeeded in shackling even a reform-minded Democratic president supposedly working with a like-minded Democratic majority in Congress. Even the modest stimulus package was hostage to charges of pork-barrel spending and the need to cut the deficit. Even though the tax increases were focused on very few Americans, those who had experienced dramatic increases in their incomes over the previous dozen years, they still barely won approval from that Democratic majority. This experience set the stage for the failure of health insurance reform a year later.

**The Economic Impact, 1993–95**

Though the financial community responded in a very positive way to the deficit reduction strategy,\textsuperscript{76} 1993 was not a dramatic year for the economy. Real GDP did not grow in the first quarter and only at the rate of 1.9 and 2.3 percent in the next two quarters.\textsuperscript{77} Investment stayed below 13.5 percent of GDP for the first three quarters, and productivity growth was negative for the first two quarters, averaging only .1 percent for the year.\textsuperscript{78} Meanwhile, the civilian unemployment rate inched down from 7.1 percent in January to 6.7 percent in October. Recall that the unemployment rate had risen from the beginning of the recession to 7.7 percent in June 1992 before beginning to fall. Such a slow decline in unemployment coupled with a weak rate of economic growth produced stagnant incomes for large percentages of the population. However, the Clinton administration tried to put as good a face as it could on this result.

In the 1994 *Economic Report*, the Clinton Council of Economic Advisers pulled out all the stops in identifying deficit reduction as the key element in an economic program that would shift spending from consumption to investment, revive the economy, and raise the long-term rate of growth. Crucial to this argument was the assertion that credible plans for reductions in deficits had already significantly reduced long-term interest rates. The council argued that the very act of proposing a serious long-term deficit reduction plan caused interest rates to come down. They identified three ways actual deficit reduction can reduce real long-term interest rates.
Lower Federal borrowing reduces interest rates directly, by reducing demand for credit.

A more prudent fiscal policy reduces the likelihood that the Federal Reserve will need to pursue a restrictive monetary policy, and so reduces expected future short term rates. . . . increased national saving leads to an increase in investment. . . . the consequent increase in the capital stock reduces the marginal product of capital and therefore the interest rate.79

This reasoning appears pretty weak. The first point is clearly true, but the others are unlikely to influence long-term interest rates. We should recall that the whole point of Greenspan’s earlier argument to Clinton was that Federal Reserve actions to alter short-term rates have *no impact* on long-term rates. Meanwhile, increases in the capital stock lower interest rates *only* if profit earned from capital investment is depressed by such an increase. If instead profits rise because the rate of growth of new technology or the efficiency with which the new capital is used increases *faster* than the capital-stock increases, the so-called marginal product of capital will actually *rise*, not fall.

The council went on to argue,

> Because the [Clinton] plan had credibility, financial markets anticipated these effects. Since future expected short-term interest rates govern current long-term rates, long rates fell immediately in response to the proposal and enactment of the Administration’s plan. There would have been no such market response if the plan had lacked credibility.80

A much more convincing explanation would have been that the financial markets, seeing a credible deficit reduction plan, believed that the likelihood of inflation in the medium future (five years or so) had been reduced. Instead of viewing future inflation dangers as contingent on the rate of growth of money, as a monetarist would argue, the financial-market decision makers were behaving as if the Keynesian vision of the world were more accurate. The way to prevent inflation was to prevent aggregate demand from growing too much. Deficit reduction, despite its potential long-term benefit if interest rates and international borrowing were to come down, has as an immediate consequence the stifling of aggregate demand, the maintenance of high levels of unemployment and excess capacity. In short, reducing the deficit banishes inflation fears by keeping the economy from getting near its potential output.

What appears to the average citizen as a *failure* of economic policy,
the laboriously slow process of reducing unemployment from 7.1 to 6.7 percent, appears to the financial-market decision makers as evidence that unemployment will not get too low to threaten inflation in the foreseeable future. It’s the prediction that accelerating inflation is not even on the horizon that causes the long-term interest rate to come down.

That’s the theory. Unfortunately for the administration, the year 1993 was the only year of success in terms of reducing long-term interest rates. By the beginning of 1994, the Federal Reserve had become alarmed at how rapidly the economy was growing. In order to avoid spooking the financial markets, the Fed again engaged in a preemptive strike against inflationary expectations. They raised the Federal Funds rate rather dramatically during the course of 1994 and 1995. This was supposed to improve expectations in the financial markets and result in a further fall in the long-term interest rates, narrowing the spread between short- and long-term rates. Indeed, the spread did narrow, but only because the Federal Funds rate rose more than the thirty-year Treasury rate. Both in real and nominal terms, the long rate actually went up.81

In terms of the macroeconomy, 1994 and 1995 were pretty good years. The recovery continued through both years. Unemployment continued to decline on average. Inflation did not accelerate. Real GDP per capita was actually lower in the beginning of 1993 than it had been at the end of 1992. However, from that point to the end of 1994, growth in that measure averaged 2.4 percent per quarter.82 The Council of Economic Advisers recognized that the decline in interest rates was carrying a much greater part of the policy burden than in previous recoveries.

If we divide GDP into its interest-sensitive components (business fixed investment, housing, and consumer durables) and everything else, the data tell a fascinating story. While the three interest-sensitive pieces typically account for about 30 percent of GDP growth, in 1993 they accounted for virtually all of GDP growth. The rest of GDP barely increased over the year.83

They also recognized that deficit reduction could go too far. That is why the administration opposed a balanced-budget amendment to the Constitution and, in the summer of 1995, attempted to stretch out the deficit reduction program from the Republican seven-year goal of a balanced budget by the year 2002 for an extra three years.
The administration argued that deficit reduction of $140 billion or so over five years was all the economy could take without endangering the recovery.

Large spending cuts or tax increases at this time would require additional large declines in long-term interest rates to replace the lost aggregate demand. Should interest rates decline by less than the required amount, economic growth would slow and jobs would be lost.\[84\]

The council estimated that in order to move to a balanced budget, the fiscal package would reduce aggregate demand so much that it would take a decline of 3 percent in long-term interest rates to offset it.

Since a 3-percent long-term interest rate [decline] seems quite unlikely, complying with a balanced budget amendment seems likely to harm the economy—perhaps severely.\[85\]

In the 1995 Economic Report, the council restated the importance of reducing the federal deficit but also noted that reducing the deficit to zero, thereby stopping the growth of the national debt, was not the primary policy goal.

A . . . reason for reducing the deficit is to reduce the debt burden that the present generation will bequeath to future generations. . . . This legacy of debt is a real concern, yet it is important not to overstate the problem or to use it as an excuse to skimp on public investment. We also bequeath to future generations a stock of physical capital—highways, airports, and the like—as well as a stock of human capital and technological knowledge. Because these add importantly to future generations’ productivity and well-being, these assets will somewhat reduce their debt burden.\[86\]

Other reasons given for reducing the deficit are instructive. The 1980s deficits had been financed, as we have noted in previous chapters, by significant borrowing from abroad. The near future should see significant demographic changes that will have a tendency to raise government spending on health and retirement programs for the elderly. Since such patterns will occur worldwide, the council warned that the foreign sources of savings that had financed government borrowing in the 1980s were not likely to be as available once those other countries find themselves devoting more and more of their national savings to financing their own budget deficits.

The third reason the council introduced actually acknowledges the
fact that sometime in the future it may be necessary to increase the budget deficit.

[A] large deficit hamstrings discretionary fiscal policy as a tool of macroeconomic stabilization. In the presence of a looming deficit, it is difficult for the Federal Government to respond to cyclical slowdown by cutting taxes or increasing spending. A gradual policy of reducing deficits can build a cushion in case the Federal Government needs to engage in countercyclical fiscal policy sometime in the future.87

This last argument is particularly significant since the GOP majority in Congress was at that very moment poised to pass a constitutional amendment mandating a balanced budget by the year 2002. The council revisited many of their arguments from the previous year, adding a major point about automatic stabilizers.

A balanced budget amendment would throw the automatic stabilizers into reverse. The Congress would be required to raise taxes or cut spending programs in the face of a recession to counteract temporary increases in the deficit. Rather than moderate the normal ups and downs of the business cycle, fiscal policy would be forced to aggravate them.88

They argued that this would result in the Federal Reserve being the only source of macroeconomic stabilization policy. However, the decreased spending by the government in the face of a recession would require such big reductions in interest rates to counteract that recession that the resulting financial instability might cause the Fed to refrain from taking such dramatic action. If the Fed were to refrain, then every recession would have the potential of turning into a depression before the three-fifths majority of Congress necessary to temporarily suspend the requirements of the amendment could be put together.

Fortunately, Congress failed to pass the amendment, which fell one vote short in the Senate in 1995. This meant that even though Congress and the president have agreed on legislation creating a spending and revenue stream leading to budget balance in 2002, should a recession arise, the automatic stabilizers will be able to increase the budget deficit as a partial cushion to the decline in aggregate demand during the recession.

The successes noted by the administration involve deficit reduction, increased government investment in education, skills, science, and technology, the so-called reinventing government program, and a
vigorous promotion of export expansion both through bilateral nego-
tiation and strong support for multilateral trade barrier reduction as
with NAFTA and GATT. The consistent argument in the 1995 report
is that though government must spend less, it must also redirect its
spending to make it more effective and must revamp the way it delivers
its services so that fewer dollars purchase more. This is an attempt to
acknowledge the powerful force of the arguments by the proponents of
the *Contract with America* that government is too big and too wasteful.
However, it is also an attempt to introduce a nuance completely absent
from the Republicans’ *Contract with America* and the sequel written in
the spring of 1995, *Restoring the Dream*. The latter two books make no
reference to anything valuable and useful that government can do
except provide national defense and engage in tough law enforcement.
Reading those books leaves one with the clear impression that those
are the only two actions that the federal government ought to be doing,
aside from providing cash transfers like Social Security and financing
Medicare. The Clinton administration spent virtually all of 1995 trying
to counter that position with the same points that were made in its *Eco-
nomic Report*: government does do some things that are essential, and
indiscriminate cuts can do more harm than good even if they do reduce
the deficit. Except on the issue of Medicare spending, they seem to have
achieved a very small response from the public.

Meanwhile, despite the rise in long-term interest rates, 1994 was a
pretty good year. Investment as a percentage of GDP rose from 13.7
percent in the last quarter of 1993 to 14.7 percent in the last quarter of
1994. The unemployment rate continued to fall, reaching 5.6 percent in
that same quarter. The rate of growth of real GDP per capita averaged
2.2 percent for all of 1994, as opposed to 1.3 percent in the previous
year. Productivity growth continued to be a disappointment. After
averaging only .1 percent in 1993, it fell in two of the first three quarters
of 1994. Finally, despite the Fed’s fears (or perhaps as a result of the
Fed’s preemptive strike) there was no hint of inflationary pressure. The
rate of inflation in the GDP implicit price deflator actually fell from 2.6
percent in 1993 to 2.3 percent in 1994.89