

Objectives for Chapter 19: Fiscal Policy and Supply-Side Economics

At the end of Chapter 19, you will be able to answer the following questions:

1. What are the theoretical effects of lowering marginal tax rates on work hours, savings, and decision-making?
2. Show, using the aggregate demand-aggregate supply graph, the theoretical results of reducing marginal tax rates.
3. What is the "*Laffer Curve*"?
4. What criticisms have been made of the supply side proposals?
5. Describe the history of the debate over having a Constitutional Amendment to require a balanced federal budget.
6. What are the arguments **against** having a Constitutional Amendment to require a balanced federal budget?
7. What are the arguments **in favor of** having a Constitutional Amendment to require a balanced federal budget?

Chapter 19: Fiscal Policy and Supply-Side Economics (latest revision September 2004)

We have mentioned the Monetarist economists. These views will be discussed in detail later. Monetarist views are associated with political conservatives. There is yet a different branch of political conservatism. This has been called "*supply side economics*". It is politically conservative in that it seeks to reduce the role of government in the American economy. Supply side economics accepts the idea of an economy that will correct its problems if only left alone. While the Monetarist economists focus on the money supply, *the supply side economists focus on the incentive effects of the tax system*. Therefore, analyzing their views requires us to return to an analysis of fiscal policy.

Supply side economists began in the middle of the 1970s. It began after the period of very high inflation created significant *bracket creep*. (*Bracket creep means that as prices rise and incomes rise accordingly, people were pushed into higher and higher tax rates.*) In the middle of the 1970s, it was not unusual for people in the middle classes to be facing *marginal tax rates* of 30% or 40%. (Remember that *the marginal tax rate is the additional tax that must be paid if one earns an additional dollar of income*. Therefore, middle class people who experienced a \$1.00 increase in income would have their taxes rise by \$0.30 to \$0.40. And that was only for the federal government. There were state taxes and social security taxes in addition.) Politically, supply side economics is associated with Congressman (later Secretary of Labor and Vice Presidential candidate in 1996) Jack Kemp and especially with President Ronald Reagan. In fact, supply-side economics has been called "**Reaganomics**". Running in the 1980 election campaign, candidate Ronald Reagan brought supply side economics into the political spotlight. When he became President Ronald Reagan, supply-side economics guided the policies for his two terms (1981 to 1989). Supply-side policies were also followed to some degree by President George Bush (1989 to 1993) and more so by his son George W. Bush (2001 to the present).

1. The Basic Arguments of Supply Side Economics

Supply side economics focuses basically on the marginal tax rate. One can summarize the main idea of supply side economics easily: *high marginal tax rates decrease aggregate supply*. The policy prescription follows from this idea: *lower marginal tax rates in order to increase aggregate supply*. Notice that the focus is on aggregate supply and not on aggregate demand. *This means that the goal of lowering the marginal tax rate is to increase production (Real GDP) by providing incentives to produce more.* The goal of lowering marginal tax rates in this view is NOT to increase the spending of consumers. Contrast this with the Keynesian view. *First, the Keynesian view focused on taxes (the total amount of tax revenues collected) whereas the supply-side view focuses on the marginal tax rates (the additional tax that would have to be paid if one earns an additional dollar of income).* *Second, in the Keynesian view, the goal of lowering taxes is to have consumers buy more goods and services.* This increased desire to buy would then cause companies to increase their production (Real GDP). The increase in incomes that result from the increases in production would then induce more consumer spending via the multiplier process. *In the supply-side view, the purpose of lowering marginal tax rates is to give people an incentive to produce more goods and services. According to Say's Law, if more goods and services are produced, more goods and services will be bought.* (“Supply creates its own demand.”)

Let us illustrate the supply side view with an example. Let us go back to 1980, the year Ronald Reagan was elected President. Candidate Reagan had made reform of the tax system the heart of his campaign. So, let us make up two families. One is a middle class family; it earned *the median income (so that half of households earned more and half of households earned less)*. In 1980, this amount was \$21,000 per year. The other family is *upper-middle income. This is typically defined as twice the median income*, or \$42,000 per year. I figured out the taxes due for each family assuming that they were Californians, that each family included four people, and that each family had taken only the standard deduction (that is, each family was not able to itemize its tax deductions). The taxes due included the federal income tax, the state income tax, and the social security tax. Now, let us give each family a \$10,000 increase in income. This might come, for example, because the family had had only one income earner. Now the family is considering having a second income earner, one who would work part time and earn \$10,000 per year. Or the \$10,000 increase in family income might be the result of overtime. One or more of the income earners in the family might have been asked to work Saturdays for an extra \$10,000 per year. Or the additional \$10,000 of family income might be the result of a promotion. One income earner might have finished an educational degree and therefore qualified for a promotion to a higher-level job paying \$10,000 per year more. In any case, the question is “how much additional tax will each family have to pay as a result of the \$10,000 increase in its income?” For the middle class family, having its income rise in 1980 from \$21,000 to \$31,000 caused its taxes (federal, state, and social security) to increase by approximately \$4,300. So for a change in income of this magnitude, the family faced a *marginal tax rate* of 43%. 43 cents out of each additional dollar earned would go to a government in the form of a tax. The family

would see only 57 cents out of every additional dollar it earned. For the upper-middle income family, having its income rise from \$42,000 to \$52,000 caused its taxes (federal, state, and social security) to increase by approximately \$6,300. So for a change in income of this magnitude, the family faced a *marginal tax rate* of 63%. 63 cents out of each additional dollar earned would go to a government in the form of a tax. The family would see only 37 cents out of every additional dollar it earned.

What is the point of this exercise? Imagine that you have a choice that would involve earning an extra \$10,000 of income. But now you learn that \$4,300, or \$6,300, of this extra income will go to a government. You will only actually have \$5,700, or \$3,700 left for yourself. What will you do? **It is reasonable to argue that you will choose not to earn the extra income.** It is just not rewarding enough to do what is necessary to earn it. So the second income earner will not work part time. Or the income earner will not agree to work on Saturdays. In either case, the number of hours worked will be lower. Or the income earner will not go for the educational degree that will qualify him or her for a promotion. In this case, the quality of the work is lower. **In any case, production will be lower.** High marginal tax rates caused the number of work hours or the quality of work to be lower. *Supply side economists argue that if the marginal tax rates were lowered, people would have more of an incentive to work because they would get to keep more of what they earn.* Empirical studies have demonstrated that their argument is valid. However, the effect seems to be small. *The marginal tax rates we have seen in the United States have reduced the number of hours worked, but only by a small amount.* (For example, it has been estimated that the tax cut of 2001, promoted by President Bush, will increase labor supply between 0.4% and 0.6% between 2004 and 2008.)

Assume that instead of wage income, we are considering interest income from savings. This is especially significant as it is the people with higher incomes who do most of the saving. Assume that the upper-middle income family could choose to save and, in doing so, would earn \$10,000 of interest income. Then they learn that more than \$6,000 of this interest income will go to the government in tax. They will actually have less than \$4,000 for themselves. What will they do? **The answer is that they will very likely choose not to save.** It is not worth it to save if the actual interest they get to keep is so little. So they might as well just spend their income. But remember that savings are used to finance business investment spending. **If less is saved, there will be less money available to lend to businesses to buy capital goods.** And since capital goods add to the ability to produce goods and services, this means that the amount of goods and services produced (Real GDP) will be less in the future than it could have been. *The conclusion of the supply side economists is that high marginal tax rates discourage saving and therefore lower business investment spending, reducing the growth rate of Real GDP.* Once again, there have been several studies of this point. The conclusion of these studies is similar to that for work hours. **High marginal tax rates do indeed reduce savings. But the effect seems to be very small.** (One of the criticisms of the supply side economists is the tendency to find effects that are valid but to exaggerate their effect. One critic put it “there is nothing wrong with supply side economics that division by ten wouldn’t cure”.)

The most compelling argument of the supply side economists is the hardest to estimate. If marginal tax rates are high, people do not just pay them. Instead, people look for ways to avoid taxes, called *tax loopholes*. (Tax avoidance should not be confused with tax evasion. *Tax avoidance* is legal. *Tax evasion* is illegal.) A common example of tax avoidance involves having a personal business. One teacher friend of mine liked to fish. So he started a fishing “business” in the summer. He bought a fishing boat and an RV. These were used to go to the Columbia River to fish for salmon. Because he would sell the salmon (only to his friends), the boat and RV were business expenses. He would keep the records for his “business” in his guest bedroom. This now became an office, allowing him to take tax deductions for all kinds of expenses normally made on his home (electricity, water, house payment, and so forth). He would deliver the salmon in his car. This now became a “business car” allowing him to take tax deductions for all kinds of expenses normally made on the car (car payment, car repairs, mileage, and so forth). The goal was for him to sell salmon for a few hundred dollars while having expenses of thousands of dollars. (But these expenses were payments he would have made anyway.) The resulting loss would be deducted from his income as a teacher in determining his tax payment. This practice was common in the early 1980s. There were many other ways to legally avoid paying taxes. In fact, there were many books published and seminars teaching people the many ways to avoid taxes. **The point is that all of these ways to reduce taxes act also to decrease production.** Starting a business whose sole purpose is to lose money (for tax purposes) is hardly productive. *The conclusion of the supply side economists is that high marginal tax rates encourage people to use the tax loopholes. But the use of tax loopholes means that these people are not producing. So production (Real GDP) is lower than it could be.* As was stated above, it is very hard to measure to see if this statement is true. However, marginal tax rates were indeed reduced beginning in 1981. Since then, both the amount of tax and the percent of total taxes paid by the richest 10% of taxpayers have increased. *This fact would provide evidence that, now that marginal tax rates are significantly lower, richer people are more likely to avoid the tax loopholes, earn the income, and pay the taxes.*

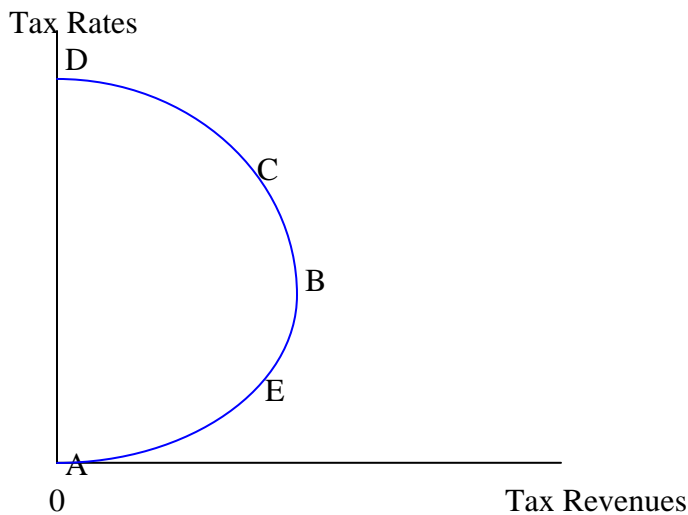
Test Your Understanding

The marginal tax rates for 1980 were given in Chapter 17 and are repeated below. The marginal tax rates for 2000 also are repeated below. Assume you have a family income of \$25,000 in 1980. Between 1980 and 2000, prices approximately doubled. So an income of \$50,000 in 2000 would represent about the same purchasing power as the income of \$25,000 did in 1980.

1. Now assume that the family income from working would rise by \$1,000. How much of this extra income would have gone to the federal government in taxes in 1980?
2. How much of the extra \$1,000 of income would go to the federal government in taxes in 2000?
3. Did the marginal tax rates of 2000 provide a greater incentive to work than the marginal tax rates of 1980? Explain why or why not.

Notice that the focus of the supply side argument is on aggregate supply (production). *High marginal tax rates reduce aggregate supply (production) by reducing the incentive to work, reducing the incentive to save, and increasing the incentive to use unproductive tax loopholes. Therefore, lower the marginal tax rates in order to create*

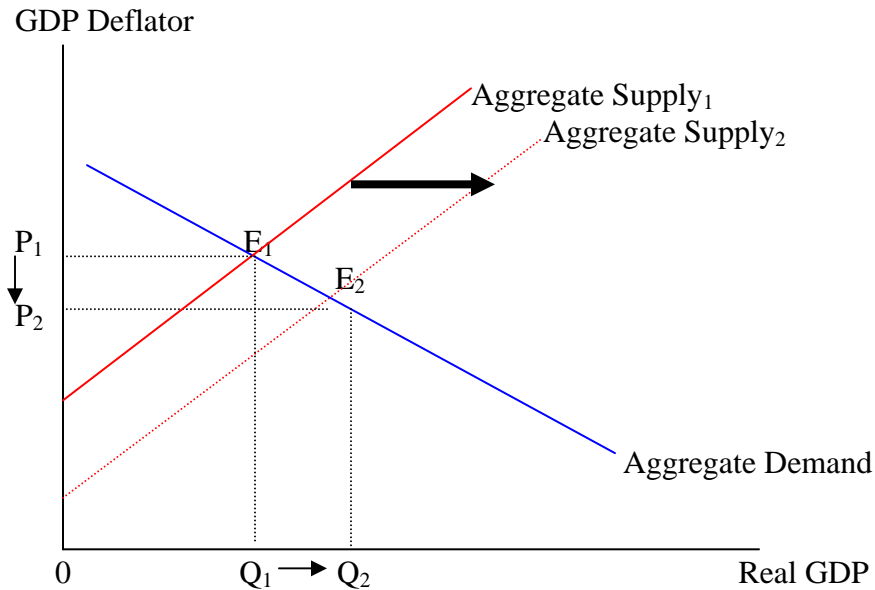
incentives to increase aggregate supply (production). The most famous part of the supply side economists' argument is associated with an economist named Arthur Laffer. In the middle of the 1970s, Laffer developed his famous *Laffer Curve*. On one axis, he plotted tax revenues. On the other axis, he plotted tax rates (presumably marginal tax rates). Point A on the curve indicates that if the government taxes at a rate of zero, it will collect no tax revenue. Point D on the curve indicates that if the government taxes at a rate of 100% (that is, if the government takes all of the income people earn), people will choose to earn nothing. 100% of nothing is equal to no tax revenue. Point B on the curve is a point that shows that, in reality, the government taxes more than zero and less than 100%. And we know that the government does indeed collect tax revenue. Connecting the points reveals a *Laffer Curve*.



In the form that it is in, it is not controversial. What made it controversial was the next statement. Laffer argued that the American economy was at a point such as C. *Therefore, his main conclusion was that lowering marginal tax rates would actually increase tax revenues.* If marginal tax rates were lowered, he argued, people would work so much more, save so much more, and make decisions to be productive. Their incomes would rise so much that, even with the lower tax rates, they would pay more in tax to the government. (For example, 50% of \$1,000 equals \$500. But 20% of \$3,000 equals \$600.) In fact, he argued, tax revenues would rise so much that the government could have all of the spending that would be socially desirable and still be able to balance its budget (that is, have a budget deficit of zero). After his assertion, people began to test the conclusion using actual data. **What was found was that Point B would be reached only when the marginal tax rates reached about 70%.** This is much higher than the levels that existed at that time (or since). In fact, the reality was a point such as E. As we will see below, because of supply side theories, marginal tax rates were lowered significantly in the 1980s. In fact, tax revenues declined and budget deficits soared.

Let us examine the conclusions of supply side economic theory using our Aggregate Demand – Aggregate Supply graph. The argument is that lowering marginal tax rates

will cause a significant increase in Aggregate Supply (production). On the graph, an increase in Aggregate Supply is shown as a shift to the right.



Notice the results. **First, the Real GDP (quantity produced) rises from Q_1 to Q_2 .** This is an *expansion*. During an expansion, the **unemployment rate falls**. All of this is good. **Second, the GDP Deflator (price level) falls from P_1 to P_2 .** This is a *deflation*. (In reality, prices are more likely to rise, but rise at a slower rate than previously --- *disinflation*.) Again, this is good. Finally, if the Laffer Curve assertion is correct, **tax revenues will also rise and the budget deficit will be reduced or eliminated**. Everything that results is good. All gain, no pain! No wonder that politicians found this view appealing. (In 1980, running against Ronald Reagan, candidate George Bush called this theory “**voodoo economics**”. But when he became Vice President George Bush and later President George Bush, he came to embrace this theory as has his son George W. Bush.)

As noted, the supply side economic theory guided the policies of the administration of President Reagan. The most significant economic policy of his first term (1981 to 1985) came with the **Economic Responsibility and Tax Act** of 1981. As was described in Chapter 17, there were two main provisions of this law. **First, and most important, was the lowering of the marginal tax rates.** President Reagan’s reasoning for this provision should be clear after the discussion of the ideas of supply side economics. The Economic Recovery and Tax Act was fully implemented by 1985. The tax rate schedules for a single person in 1980 and in 1985 are repeated below. **Notice that the marginal tax rates are lower in 1985 than they were in 1980 (25% lower in fact).** Notice especially that the highest marginal tax rate fell from 70% to 50%.

1980: If income is:	You Pay	
0 – 2,300	0	
+2,301-3,400	14%	of the amount over 2,300
+3,401-4,400	16%	of the amount over 3,400
+4,401-6,500	18%	of the amount over 4,400
+6,501-8,500	19%	of the amount over 6,500
+8,501-10,800	21%	of the amount over 8,500
+10,801-12,900	24%	of the amount over 10,800
+12,901-15,000	26%	of the amount over 12,900
+15,001-18,200	30%	of the amount over 15,000
+18,201-23,500	34%	of the amount over 18,200
+23,501-28,800	39%	of the amount over 23,500
+28,801-34,100	44%	of the amount over 28,800
+34,101-41,500	49%	of the amount over 34,100
+41,501-55,300	55%	of the amount over 41,500
+55,301-81,800	63%	of the amount over 55,300
+81,801-108,300	68%	of the amount over 81,800
+108,301+	70%	of the amount over 108,300

1985: If income is:	You Pay	
0 – 2,390	0	
+ \$2,391-\$3,540	11%	of the amount over \$2,390
+ \$3,541-\$4,580	12%	of the amount over \$3,540
+ \$4,581-\$6,760	14%	of the amount over \$4,580
+ \$6,761-\$8,850	15%	of the amount over \$6,760
+ \$8,851-\$11,240	16%	of the amount over \$8,850
+ \$11,241-\$13,430	18%	of the amount over \$11,240
+ \$13,431-\$15,610	20%	of the amount over \$13,430
+ \$15,611-\$18,940	23%	of the amount over \$15,610
+ \$18,941-\$24,460	26%	of the amount over \$18,940
+ \$24,461-\$29,970	30%	of the amount over \$24,460
+ \$29,971-\$35,490	34%	of the amount over \$29,970
+ \$35,491-\$43,190	38%	of the amount over \$35,490
+ \$43,191-\$57,550	42%	of the amount over \$43,190
+ \$57,551-\$85,130	48%	of the amount over \$57,550
+ \$85,131+	50%	of the amount over \$85,130

In 1986, President Reagan proposed a more sweeping reform of the federal income tax law. Again, his proposal was enacted into law. The main provision of this law, as with the 1981 law, was **to lower the marginal tax rates**. The number of tax brackets was reduced. The new tax rate schedule for a single person in **1986** is repeated below:

Adjusted Gross Income	Marginal Tax Rate
0 - \$19,450	15%
\$19,451 - \$47,050	28%
\$47,051 - \$97,620	33%
\$97,621+	28%

Notice how much lower the highest marginal tax rates were compared to the highest marginal tax rates of 1980. The reason for this change should be clear.

In 1991, the 33% marginal tax rate and the top 28% marginal tax rate were combined into one 31% marginal tax rate. So for **1992** (the last year of the Bush presidency), the tax rate schedule for a single person looked as shown below.

Adjusted Gross Income	Marginal Tax Rate
0 - \$21,450	15%
\$21,451 - \$51,900	28%
\$51,901+	31%

We considered the changes under President Clinton in Chapter 17. As of **2000** (the last year of the Clinton presidency), the tax rates looked as follows:

Adjusted Gross Income	Marginal Tax Rate
0 - \$26,250	15%
\$26,251 - \$63,550	28%
\$63,551 - \$132,600	31%
\$132,601 - \$288,350	36%
\$288,351+	39.6%

In 2001, George W. Bush became President. A major part of his campaign had involved a proposed reduction in marginal tax rates. In May of 2001, President Bush's tax reduction proposal was enacted into law. Called the "***Economic Growth and Tax Relief Reconciliation Act of 2001***", it created a new tax bracket of 10%, effective January 1, 2001. This was estimated to lower tax payments by \$300 for a single person and \$600 for a married couple. These tax reductions were sent to people as checks in 2001. The marginal tax rates for a single person for 2002 look as follows:

Adjusted Gross Income	Marginal Tax Rate
0 - \$6,000	10%
\$6,001 - \$27,950	15%
\$27,951 - \$67,700	27%
\$67,701 - \$141,250	30%
\$141,251 - \$307,050	35%
\$307,051 +	38.6%

In 2003, further changes to the tax law were passed under the influence of President Bush. The marginal tax rates were reduced once again, as shown below. There were several other tax changes passed in the 2003 law.

Tax Schedule for 2003 for a Single Person

Income	Marginal Tax Rate
0 to 7,000	0
7,001 to 28,400	15%
28,401 to 68,800	25%
68,801 to 143,500	28%
143,501 to 311,950	33%
Over 311,950	35%

2. Criticisms of Supply Side Economics

Needless to say, a view like that of supply side economics is very controversial. Among economists, there are several criticisms of this view. The first one has already been mentioned. This criticism is that, even though the conclusions of the supply side view have validity, **the effect is exaggerated**. Lowering marginal tax rates will likely provide people with greater incentives to work and to save. But these effects are likely to be very small --- too small to create any significant improvement in economic behavior.

A second important criticism involves the Laffer curve. This curve argued that lowering marginal tax rates would increase production (and therefore incomes) so much that tax revenues would actually increase. The 1981 and 1986 tax changes were justified by this argument. But subsequent research has shown that marginal tax rates would have to be much higher than they have been for this effect to operate. **In fact, the lowering of marginal tax rates in 1981 and 1986 coincided with a large increase in federal government budget deficits**. From having federal government budget deficits of about \$60 billion in 1981, the United States experienced federal government budget deficits of more than \$100 billion in 1982 and then more than \$200 billion in 1983. These federal government budget deficits stayed at very high levels, reaching a peak of \$290 billion in 1992. As we will see below, the federal government budget deficits have serious effects in slowing economic growth. An analysis of the effects of these budget deficits comprises the remainder of this chapter.

A third important criticism involves the fact that the view of the supply side economists focused exclusively on aggregate supply. By doing so, **it ignored the effects of decreases in marginal tax rates on aggregate demand**. Lowering marginal tax rates may indeed increase the incentives for people to work and to save. But doing so also provides greater disposable income. This increase in disposable income increases consumer spending. Many economists argue that the benefits of the decrease in the marginal tax rates came more as a result of the effect it had on consumer spending than on incentives to produce.

Finally, a fourth important criticism involves the distributional effect of the policy of lowering the marginal tax rates. **An across-the-board decrease in marginal tax rates provides greater benefit to richer people than to poorer people**. Richer people are those in the highest tax brackets and are the people who pay most of the taxes. In fact, as we saw, poor people may pay no federal income tax at all and therefore would receive no benefit from the policy of lowering marginal tax rates. The period from 1980 on was a period of increasing inequality of income in the United States. Some people argue that the policy of lowering the marginal tax rates in the 1980s contributed to this widening inequality.

Test Your Understanding

The period 2001 was a period of recession. Production fell until the 4th quarter of 2001 and then rose slowly during 2002. Unemployment rose consistently from early 2001 through 2002. Inflation rates were very low in this period. The tax revenues fell as the economy suffered its recession and slow recovery. Government spending rose, largely due to the events of September 11, 2001. The result is that the federal government now has a budget deficit. Budget deficits are predicted for the federal government every year through 2010. **If you are a supply side**

economist, what policies would you recommend be undertaken at the present time. Explain your justification for these policies.

3. The Constitutional Amendment to Require a Balanced Federal Budget

Let us turn our attention again to the federal government budget deficits. The United States government experienced a budget deficit (that is, it spent more than it took in as tax revenues) every year from 1954 to 1998 (except for one year, 1969). As mentioned earlier, beginning in 1982, the amount of these deficits passed \$100 billion. The 1980s and early 1990s were years of very high federal government budget deficits, with the greatest deficit coming in the year 1992 at \$290 billion. For fiscal year 2004, the budget deficit is projected to be more than \$400 billion. As we know, budget deficits are financed by borrowing. The total amount of all of this borrowing is called the *national debt*. The national debt today is about \$7.3 trillion. Of this \$7.3 trillion of borrowing, about \$6.4 trillion has occurred since 1980. By 2010, this national debt is projected to pass \$10 trillion.

Several times there have been attempts to pass an amendment to the United States Constitution that would require the federal government to eliminate its budget deficit and have a balanced budget every year. There are two ways to amend the United States Constitution. One way requires 2/3 of the members of the House of Representatives (291) and 2/3 of the member of the United States Senate (67) to pass the amendment. The amendment must then be approved (“ratified”) by 75% of the state governments (38). In this case, the Constitutional Amendment to require a balanced federal budget was passed by the House of Representatives. In the Senate, it received 66 votes, falling one vote short of the 2/3 vote requirement. The second way to amend the United States Constitution has never been used. This way is for 2/3 of the state legislatures (34) to petition Congress to hold a constitutional convention for the purpose of amending the constitution. At one time, 32 state legislatures had done so for the purpose of adding this particular Constitutional amendment.

Congress got very nervous at the thought on a constitutional convention. There had not been one since 1789. So Congress decided to try to eliminate the need for it by eliminating the federal government budget deficits. In 1987, Congress passed the so-called *Gramm-Rudman-Hollings Act*. (Phil Gramm was the Republican Senator from Texas. In 1985, he was a Congressman from Texas. Warren Rudman was the Republican Senator from New Hampshire. And Ernest Hollings is the Democratic Senator from South Carolina.)

The Gramm-Rudman-Hollings Act had two main provisions. **First, there were to be upper limits on the budget deficit for each year.** For fiscal year 1990, the upper limit on the budget deficit was to be \$100 billion. This means that Congress and the President were obligated to agree on the government budget that would incur a deficit of no more than \$100 billion. The upper limit was to be reduced by \$36 billion each year until it reached zero in fiscal year 1993. **The second provision was that, if the Congress and the President could not agree on a government budget that incurred the required deficit (and no more), there were to be automatic reductions in government spending to achieve the target.** Half of the reductions were to come from the budget for defense. The other half was to come from other programs. So for example, suppose the

President and the Congress could only agree on a certain budget for fiscal year 1990. Assume that that budget would lead to a budget deficit of \$120 billion (that is, it would spend \$120 billion more than the estimated tax revenues). Since the upper limit was \$100 billion, \$20 billion would have to be cut from government spending --- \$10 billion from defense and \$10 billion from other programs.

In 1990, the government faced a dilemma. Because the country was entering a recession, the estimated tax revenues were low. In order to meet the upper limit of the deficit (\$64 billion), huge reductions of government spending would be required. These were unacceptable. So several meetings between the leaders of each house of the Congress and representatives of President Bush led to an agreement. In order to reduce the budget deficits in the future, certain reductions were made in government spending. **Perhaps the most important change made in this agreement was to require that all new government spending programs must pay for themselves.** This means that if a member of Congress proposes some program that would increase government spending, that person is also required to propose either the increase in taxes or the decrease in some other program of government spending in order to pay for it. **Finally, the 1990 agreement generated an increase in taxes --- particularly increased gasoline, tobacco, and alcohol taxes as well as some new luxury taxes.**

In 1993, the newly elected President Clinton again saw the need to reduce the budget deficits that, as noted earlier, had risen to the all-time high of \$290 billion in 1992. His proposal involved a decrease in some government spending programs (compared to the amount of spending that had been projected) and some tax increases (mainly increases of the gasoline tax and of the income taxes on the “rich”). His proposal was passed by both houses of the Congress with most Democrats voting for it and all Republicans voting against it. As we will see later, beginning in 1993, the budget deficits finally began to decline. They were completely eliminated by 1998. In the years from 1998 to 2000, the United States experienced significant budget surpluses. How much of the decline in the budget deficits is the result of the policy of President Clinton in 1993 has been debated. (This was a Test Your Understanding question of Chapter 18.) But the decline in the budget deficits to zero did eliminate the push to try to pass an amendment to the Constitution to require a balanced federal budget.

Let us consider this amendment to the United States Constitution. There are many important arguments concerning it. Let us begin with the arguments **against** passing such a Constitutional amendment. **The main argument of those of who opposed the Constitutional amendment involves the automatic stabilizers.** Let us assume that the country enters a recession, as it did in 2001. What will happen to government spending? The answer is that it will automatically increase. **Spending on unemployment benefits, welfare, and social security will increase as more people become entitled to them.** And what will happen to tax revenues? The answer is that they will decrease. **As people’s income decline, the amount of tax they will pay will also decline.** If government spending rises and tax revenues fall, the budget deficit must rise. When we first encountered this, we said that this budget deficit was actually desirable. But if there were a Constitutional amendment that requires the federal government to have a balanced budget, the deficit would not be allowed. How would the government eliminate the budget deficit? The answer is that it would have to either reduce government spending or

raise taxes (or both). If the government reduced its spending or raised taxes in a period of recession, what would happen to the recession? The answer, of course, is that the **recession would become more severe**. When unemployment is already high, the federal government would be forced by the Constitution to undertake actions that would throw even more people out of work. **The people who make this argument believe that budget deficits are helpful when the economy is experiencing a recessionary gap**. Because these budget deficits are desirable, the government should be able to have them.

Test Your Understanding

In 2001 and 2002, the economy of the state of California experienced a serious recession. Tax revenues fell for the state. As a result, the state of California experienced a budget deficit of over \$23 billion. By its Constitution, the state of California is not allowed to have a budget deficit. Go on the Internet or to any major newspaper. You can visit that site for the state of California if you wish. What actions were taken by the state government to eliminate the budget deficit? That is, what was done to California government spending? What was done to taxes in California? Considering that California is a very large state, what are the likely effects of these policies?

A second argument of those who oppose the Constitutional amendment relates to the balanced budget multiplier. Remember from Chapter 18 that the government purchases multiplier is greater than the tax multiplier. (Review this now if you don't remember these concepts.) Suppose the government decided to decrease taxes. In order to maintain the balanced budget that would be required by this Constitutional amendment, the government could reduce its purchases by a like amount. **But since the decrease in government purchases has a larger effect of aggregate demand (total spending) than the decrease in taxes, the net effect would be to reduce aggregate demand (total spending) and therefore to throw the country into a recession**. These people argue that economic outcomes (such as recession) are more significant than the federal government's budget deficit.

A final argument of those who oppose the Constitutional amendment relates to its enforceability. As we saw in Chapter 16, some of the federal government's spending is considered "*off budget*". Because it is off budget, it is not considered in the official measure of the budget deficit. Someone wanting to increase government spending for some purpose and yet not have the official federal government budget deficit increase could simply have that spending be considered "*off budget*". There are many other kinds of accounting gimmicks that can be used to avoid the prohibition on a budget deficit.

Test Your Understanding

Before you read the next section, think of as many reasons as you can as to why budget deficits of the federal government would be bad for the economy. Write them down. Then read the next section and compare your answer.

Now let us consider the arguments of those who **favor** a Constitutional amendment to require the federal government to have a balanced budget every year. These people acknowledge that budget deficits may be helpful during times of recession. But they argue that the federal government has had budget deficits most of the time. The federal government has not been able to limit the budget deficits to those times when they might

be desirable. At other times, the budget deficits are harmful. Therefore these people believe that the country would be better off if the budget deficits were not allowed.

What is so bad about the federal government's budget deficits? The most important reason to believe that budget deficits are harmful is the *crowding out effect*. This was first explained in Chapter 18. When the federal government incurs a budget deficit, it obtains this money by borrowing. Because the federal government is borrowing in large amounts, interest rates rise. The increase in interest rates causes a decrease in both consumer spending and business investment spending. The concern is with the decrease in business investment spending. As we know, business investment spending is the buying of capital goods by businesses. Capital goods are used to increase production (Real GDP). **If the government borrows this money, the businesses cannot buy the capital goods. Production (Real GDP) will not increase. Production (Real GDP) is significantly lower today than it would have been had the federal government never incurred budget deficits.** (Notice that production is not lower today than it used to be. But it is lower today than it could have been. **The United States would be a richer country today if the budget deficits had never happened.**)

A related reason to eliminate budget deficits is that these **budget deficits contributed to the American trade deficits**. As stated in the last paragraph, when budget deficits are incurred, interest rates rise. **When interest rates rise, the American dollar appreciates** (review this example in Chapter 7). **When the American dollar appreciates, American exports decrease while American imports increase. The American trade deficit is increased.** (The phrase **"twin deficits"** was used commonly during the 1980s.)

A third reason to eliminate budget deficits is that if the economy is not experiencing a recessionary gap, **budget deficits can add to inflationary pressures**. Budget deficits act to increase aggregate demand (total spending). If aggregate demand (total spending) is already sufficient, then increase can create **"too much spending"**. This would cause inflation. Alternatively, as we have just said, the budget deficits cause interest rates to increase. We know that the Federal Reserve makes its policy by targeting interest rates. If the Federal Reserve does not want the interest rates to increase, it can drive interest rates down by increasing the money supply. (This act is called **"accommodation"**.) But **increasing the money supply can cause inflation**. This argument is placed third in our order because it has become a more difficult argument to accept. **The period from 1981 through 1992 was a period during which the federal government budget deficits were the highest. Yet, this period was accompanied by disinflation --- inflation rates declined to very low levels.** So the federal government budget deficits must have a smaller effect on inflation rates than other factors.

Besides the belief that budget deficits are harmful to the economy for the reasons listed, **supporters of the Constitutional amendment believe that it would bring discipline to government**. As we have seen, the government's spending decisions are entirely separate from its tax revenue decisions. This is, of course, contrary to the experience of everyone else. The government chooses to spend as it believes is best. It then collects the tax revenue. If the tax revenue is not sufficient to pay for all of the spending, the government simply borrows the remainder. The government does not have

to set priorities in its spending the way families and businesses do. **An amendment to the Constitution requiring a balanced budget would force the government to set such priorities.** If the revenues were not sufficient to pay for all of the desired spending, the government could either raise revenues (hard to do politically) or it would have to reduce spending. It would have to come to a conclusion that while program A and program B are both desirable, program A is more desirable than program B and there is only enough revenue to pay for one of the programs.

The debate over the Constitutional amendment to require a balanced federal budget faded away in the late 1990s for two reasons. **First, the federal government budget deficits declined greatly until 1998. Then from 1998 to 2001, the federal government actually incurred budget surpluses.** What to do about these surpluses was a major campaign topic in the 2000 election. **Second, the pay-as-you-go system created in 1990 did indeed create discipline in government spending.** Since 1990, no one can propose an increase in government spending in any area without either proposing a specific tax increase to pay for it or a specific decrease in some other area of government spending. **However, beginning in 2001, budget deficits emerged once again.** Therefore, it is reasonable to assume that the proposal to enact this Constitutional amendment will emerge once again. If it does, there will be a great debate on the issue. This section has pointed out some of the most important economic arguments on both sides of the issue. Hopefully, this helps you to clarify your own position.

4. The Budget Deficits of the Early 21st Century

As noted, budget deficits came into existence in 2001 once again. They came into existence for three reasons: (1) the recession of 2001 followed by a very slow recovery, (2) the increase in government spending related to Homeland Security and to the wars in Iraq and Afghanistan, and (3) the tax cuts of 2001 and 2003. Over the ten years **from 2002 to 2011, it is now estimated that the federal budget has shifted into deficit by \$6 trillion in total** (averaging about 3% of GDP for each of the years). Because of the crowding-out effect, this shift into budget deficit would cause the income of every household in America to be \$1,800 less than it would have been without the deficits (\$700 for every person). However, it is possible that these budget deficits provided short-term stimulus to help get the economy out of the 2001 recession. The budget deficit of 2003, at \$401 billion, is the highest budget deficit on record. As shown below, the Congressional Budget Office (CBO) projects that the budget deficits will be reduced until they are finally eliminated in 2011. Thereafter, CBO predicts budget surpluses. However, some economists believe that this prediction is unrealistic. Based on different assumptions, they project huge budget deficits over the next ten years. As this is written (February 2004), Democrats are criticizing the Bush administration for these budget deficits, especially the part caused by the tax cuts. Some conservative Republicans are also expressing concern. Critics argue that these budget deficits will increase interest rates (an estimated one percentage point), will increase American dependence on foreigners (who bought 58% of the new debt in 2002), and will increase the interest payments of the federal government, making it harder for the government to pay for

adequate education, health care, and so forth. The Bush administration, of course, defends its policies. This is likely to be a major topic for the 2004 presidential election.

Year	CBO Estimated Deficit	Economists Adjusted Estimated Deficit
2003	\$401 billion	\$401 billion
2004	480	491
2005	341	435
2006	225	430
2007	203	449
2008	197	479
2009	169	499
2010	145	521
2011	9	576
2012	(160) Surplus	581

5. Conclusion

The 1980s was a decade of political conservatism in the United States and elsewhere. In reaction to the high rates of inflation prevailing in the late 1970s and early 1980s, the views of the Monetarist economists gained prominence. Much monetary policy was made with their views in mind. Under Presidents Reagan and Bush, fiscal policy was based largely on the views of the supply side economists. The Keynesian Revolution was definitely over. One aspect of the low influence held by the Keynesian view was the continual attempt to eliminate federal government budget deficits that were described in this chapter. The country came very close to enacting an amendment to the Constitution that would have mandated such an elimination of federal government budget deficits. The pros and cons of such an amendment were debated in this chapter. Had such an amendment been passed, the Keynesian tools of fiscal policy discussed in Chapter 18 would have been rendered useless.

The period of the 1990s was a different decade altogether. The supply side view became less significant as a result of the very high federal budget deficits that occurred in the 1980s. However, the supply side view came back into prominence with the election of George W. Bush as President in 2000. There are still disagreements among economists, of course. But there has been much more of a synthesis of the views. We will examine the decade of the 1990s in Chapter 27. But before we look at this most recent decade, we need to consider the other main policy tool --- monetary policy.

Practice Quiz for Chapter 19

- According to the **supply side economists**, lowering marginal tax rates will cause:
 - work hours to increase
 - savings to increase
 - tax revenues to increase
 - all of the above
- The **Laffer Curve** says that
 - as unemployment rates fall, inflation rates rise
 - as aggregate demand falls, aggregate supply rises
 - as marginal tax rates fall, tax revenues rise
 - as the price level rises, aggregate demand falls

3. If lowering marginal tax rates does indeed bring about the results that are expected by the supply side economists, which of the following will result?
 - a. Real GDP will rise
 - b. unemployment will rise
 - c. the price level will rise
 - d. all of the above
4. **“Reaganomics”** is most associated with
 - a. Keynesian economics
 - b. Monetarist economics
 - c. Supply side economics
 - d. All of the above
5. Which of the following was a result of the proposals of President Reagan in the 1980s?
 - a. the marginal tax rates were lowered
 - b. the money supply was decreased
 - c. the budget deficits were eliminated
 - d. income taxes were increased
6. What was the purpose of the **Gramm Rudman Hollings Act** of 1987?
 - a. to reduce marginal tax rates
 - b. to increase government spending
 - c. to eliminate the federal budget deficits
 - d. to increase the money supply
7. If the United States enters a recession and there is a **Constitutional amendment** requiring that the federal government always have a budget deficit, which of the following will result?
 - a. the recession will be eliminated
 - b. the recession will become worse
 - c. the money supply will be increased
 - d. taxes will automatically have to be reduced
8. Budget deficits in normal times are considered **“bad” for an economy** because they cause
 - a. recession
 - b. crowding out
 - c. lower interest rates
 - d. disinflation
9. If there is a **federal government budget deficit**,
 - a. interest rates rise, the dollar appreciates, exports fall, imports rise, and the trade deficit rises
 - b. interest rates rise, the dollar depreciates, exports rise, imports fall, and the trade deficit falls
 - c. interest rates fall, the dollar depreciates, exports fall, imports rise, and the trade deficit rises
 - d. interest rates rise, the dollar appreciates, exports rise, imports fall, and the trade deficit falls
10. Which of the following economic views is generally **NOT** associated with political **conservatives**?
 - a. the Monetarist view
 - b. the Keynesian view
 - c. the Supply side view