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# THE GOOD-FOR-NOTHING BUDGET

## Clinton-GOP deal a boon to the wealthy, but not the economy

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Government budgets reflect social values. The five-year budget agreement proposed by the president and the Republican congressional leadership represents a decision to sacrifice investment in the future productivity and earnings of working people in order to increase the current incomes of wealthy Americans, maintain excessive military spending, and reduce deficits in the near term only to increase them in the long run.

As a result of this budget agreement:

- The share of national income reinvested in education, training, infrastructure, and civilian research and development will continue to decline.
- Military spending will remain too high.
- Tax cuts -including a reduction in the capital gains tax and an increase in the estate tax exemption -will redistribute income to the wealthy and to investors who have been enjoying record stock market gains.
- The budget may be balanced, but the economy will be no better for it.

Judging by this budget, it appears we are no longer putting people first. The leaders of the nation can do better.

### Public investment continues to decline as share of GDP

Under the proposed budget deal, the nation will continue to slight public investment-those investments in infrastructure, research and development, and education and training that are important ways in which the government stimulates economic growth and private sector productivity. In fiscal year 1997, such spending is estimated to reach $136 billion. The president's original budget proposed a reduction in public investment to $133 billion in FY1998, or to 1.6% of gross domestic product. In contrast, such spending was as much as 1.9% of GDP in the Bush Administration and 2.5% when Ronald Reagan was president. Merely returning to the Reagan-era level would require more than an additional $60 billion annually.

While the budget projections do not specify the level of public investment beyond 1998, we can estimate these figures based on other components of the budget projections and current spending trends. In 1997, public investment is about half (48%) of domestic discretionary spending. Clinton has agreed to reduce domestic discretionary spending by $60 billion over five years, meaning nearly $30 billion in public investment would be lost. Public investment would fall in nominal terms, and the decline in real spending and as a share of GDP would be even greater. While this budget proposes tax credits for higher education costing about $35 billion, at least half and probably more of this amount is mere tax relief, generating no investment. Ultimately, the net effect of the budget deal is to retard public investment and economic growth.

## Military spending at Cold War levels

Although military spending is being cut below baseline projections and is falling as a share of GDP, further cuts are still warranted. In real terms, current spending is comparable to that spent during the height of the Cold War. A number of experts have pointed out that the United States could easily phase in reductions totaling $200 billion over the next 10 years without sacrificing its overwhelming military superiority.

## Tax cuts for the wealthy

The budget deal gives a green light to congressional Republicans to enact a number of tax cuts, with $85 billion over the next five years set aside for this purpose. The leading Republican proposals center around cutting taxes on capital gains. Despite claims to the contrary, this tax cut would serve no productive economic purpose. In the best of circumstances, a capital gains tax cut can have only a minimal effect on investment. At present, the after-tax profit rate is higher than it has been at any point in the last 40 years. If this high rate is not providing an incentive for firms to invest, then it is difficult to see that anything as indirect as a capital gains tax cut could have a positive impact. Furthermore, the stock market is already at a record high; even Alan Greenspan has stated publicly that the market may be overvalued. A capital gains tax cut could further push up stock values, setting the stage for a precipitous decline at some point in the future. In addition, by providing preferential treatment for capital gains over other income, the government is inviting people to manipulate the system so that ordinary income can appear as capital gains.

In the end, only the wealthiest Americans will benefit from a capital gains tax cut. As recently as 1992, fewer than 30% of households owned at least $2,000 of stock. Approximately 75% of all stock owned by individuals, including stock held in defined-contribution pension plans, is held by households with incomes of over $100,000 per year. **A** capital gains tax cut means that these already wealthy families will have a significant portion of their incomes taxed at a 19% rate, while working families earning $40,000 a year will face a 28% marginal tax rate.

The capital gains tax cut and indexing of capital gains is just one way this budget would benefit the wealthy: tax breaks for individual retirement accounts and a reduction in the estate and gift tax are also on the table. Besides leading to revenue losses, the proposed changes will make the tax system more complicated and increase opportunities for high-income persons to legally avoid taxes.

## The legacy of backloaded tax cuts

The cost of many of these tax breaks will rise substantially after 2002, overshadowing the cost of the $500 per child tax credit and making the maintenance of low deficits more difficult in the future. The Joint Committee on Taxation has estimated that, in the five years after 2002, tax cuts proposed by the GOP will cost an additional $165 billion, almost twice as much as in the preceding five years, for a total cost of $250 billion. This huge jump occurs because the costs of the proposed tax cuts are "backloaded," meaning that the revenue losses will increase in the years after the targeted budget-balancing year of 2002.

The capital gains tax cut and the indexing of capital gains are big revenue losers, estimated to cost $129 billion over the first 10 years. The lower rate induces a wave of selling in the first few years, increasing revenues and reducing losses, while in later years the realization of gains slows and the revenue losses increase. Indexing capital gains, which will occur after three years, will exacerbate this problem. Indexing will allow savings to compound for those holding assets, reducing the taxes due when the asset is ultimately sold.

Republicans have proposed tax cuts that have the effect of reducing deficits before 2002 but increasing them afterwards. In particular, the proposals for capital gains relief and the expanded individual retirement accounts not only disproportionately favor high-income persons, they backload costs. By contrast, the $500 per child tax credit is not even indexed to inflation and will diminish in value over time. If an $85 billion tax cut is inevitable, the best course is to concentrate the remaining resources on children and education and minimize the expansion of tax-based welfare for corporations and high-income persons.

## Misguided push for a balanced budget

Both Democrats and Republicans have adhered to the goal of a balanced budget by FY2002, although recent reports by the Congressional Budget Office show there is little benefit to such a policy. In its January Economic ***and Budget Outlook,*** the CBO estimates that, relative to a policy of continuing with currently projected deficits in the range of 1.5% to 2.0% of GDP, if the budget were balanced by 2002 and remained balanced every year thereafter, by 2007 GDP would increase by less than one-half of 1%, or a gain of $160 (in 1997 dollars) per person. The CBO also compared the long-term consequences of both a balanced budget policy and a policy of maintaining the deficit at its present share of GDP. It found that, in either case, real GDP per capita will double between 1996 and 2050. The difference in income between the two policies — i.e., the gains from 55 years of budget balance-was only 2.5% of per capita GDP. This small gain occurs at the cost of ***55*** years of reduced government services. It is a remarkably small gain given that the benefits of deficit reduction are supposed to grow over time.

It has rarely been mentioned in the budget debates that spending cuts and tax increases are not the sole route to a balanced budget: faster economic growth can also move the government out of the red. When President Clinton took office, most analysts did not believe the unemployment rate could fall below 6%, and they made their budget projections accordingly. The greater-than-expected decline in the unemployment rate has added more tax revenue than was projected and has reduced expenditures on unemployment compensation and other benefits. If the deficit had been reduced more quickly, as many advocated, it would have slowed economic growth and raised unemployment, requiring even more severe spending cuts to balance the budget.

## Negotiators accept CPI as best gauge of inflation

The budget negotiators are to be commended for avoiding an easy, but misguided, route to balancing the budget: changing the way inflation is calculated. The budget agreement's treatment of the consumer price index, and the taxes and expenditures that are tied to it, is the correct approach. Under the agreement, the determination of the rate of inflation will be left to the Bureau of Labor Statistics. This decision protects the principle that the political process of deciding what to do with economic data should be kept separate from the process of compiling it. Furthermore, by not reducing the indexation formula, the agreement will protect the living standards of both elderly people dependent on Social Security and the working poor, who would have been hurt by reductions in the earned-income tax credit.

## More government shutdowns?

The latest breaking development in negotiations suggests that the budget might include new sequester language. On the eve of the agreement, the negotiators revised their economic projections to assume an additional $225 billion in revenues over five years. If, however, this forecast proves to be overly optimistic, the sequester legislation would trigger automatic spending cuts. This would be an extremely bad policy for two reasons. First, cuts in spending would be made without recourse to tax increases and without regard for the relative merits of different programs. Second, the cuts would come at precisely the wrong time — when the economy is slowing down. Much like the balanced budget amendment, sequesters would interact perversely with the business cycle by lengthening a recession. These sequesters could also give rise to the same kind of legislative impasses that shut the government down during the Reagan and Clinton administrations.

## Conclusion

Americans will pay a high price for this balanced budget. Public investment continues to fall as a share of GDP, and military spending remains unnecessarily high. This budget deal also gives large tax breaks to the wealthy that will exacerbate the budget squeeze in the future, but it does not make a serious effort to rebuild the weakened social safety net. Building a more prosperous America for the 21st century requires more than this budget provides.

## Further Reading

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