BY ROB NORTON

**The most startling** feature of the economic policy debate during the presidential election of 2000 and of the current debate over the United States budget is the Democratic Party's unwavering support for sustaining the federal budget surplus.

From the July Democratic National Convention (when Al Gore beat back a series of attempts by the liberal wing of the party to call for increases in social spending and to deemphasize fiscal restraint), through the ensuing election campaign (when Gore repeatedly warned against "squandering the surplus"), to today's debate over President Bush's plan to cut tax rates, the Democrats' primary domestic-policy aim is to preserve fiscal responsibility and future budget surpluses.

To say that the Democratic Party's position wasn't ever thus is to understate the case. The idea of balancing the budget – let alone running a surplus – is historically associated with the Republicans. Especially in the post-World War II decades, when Democratic policy making was influenced by Keynesian economists (and Republican policy making was informed by economists who were most easily described as anti-Keynesian), the idea that a balanced budget was inherently virtuous was seen as reactionary and anachronistic. Discretionary fiscal policy, in the postwar Keynesian view, held that budget deficits were generally acceptable, and should be used as a tool to boost federal spending to achieve the high-priority goal of full employment.

If anyone needed proof that balancing the budget was the wrong way to go, they were reminded of the last time the fiscal house was kept in order for an extended period of time: the prelude to the Great Depression, from 1921 to 1930. Indeed, the idea of balancing the budget was ridiculed by the ascendant generation of Keynesians as "Herbert Hoover economics."

So how did the Democratic Party morph from its traditional embrace of fiscal profligacy to its laser-like focus on budget balance, and how did the Republican Party lose its preeminent position as the party of rock-ribbed fiscal rectitude? Or as put more colorfully by Robert Reischauer, former director of the Congressional Budget Office and now president of the Urban Institute, how did we arrive at the current state of "policy cross-dressing?"

### CROSS DRESSING REVEALED

There are at least three explanations. The first reflects a sea change in the views of academic economists. Through the 1960s, Keynesians ruled academia. Although the great English economist never directly recommended defi-

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cit finance as a tool of stabilization, his followers – notably Abba Lerner, the founder of the Keynesian theory of public finance – believed that government spending and taxation should be manipulated in the interest of maximizing employment rather than for producing a balanced budget per se. An important intermediate goal was to help the economy avoid recessions.

This Keynesian view reached its apogee of influence during the JFK administration, whose advisors included two future Noble laureates, James Tobin and Robert Solow. One tangible result was the cut of 1964, designed to increase output and lower unemployment by stimulating investment.

The Keynesian consensus came under profound attack in the early 1970s by the profoundly conservative school of "rational expectations." Its manifesto was a paper by the University of Chicago economist and future Nobelist Robert E. Lucas Jr., "Econometric Policy Evaluation: A Critique," which circulated in draft form for several years before its publication in 1976. The Lucas Critique, as it came to be known, argued that the static economic models upon which Keynesian policies relied were fatally flawed because they ignored the impact of policy changes on the way economic actors behaved.

The rational expectationists believed that once policy changes were announced, individuals and businesses would alter their saving and spending behavior in ways that offset the impact. A budget deficit, for example, would be seen as creating a debt that would have to be repaid down the road with an increase in taxes. As a result, much of the impact of countercyclical policy like tax-rate and interest-rate changes would be dissipated.

The Lucas Critique blew a giant hole in the theoretical foundations of Keynesian theory, and changed the way nearly all economists – including those disinclined to accept rational expectations as the new gospel – viewed macroeconomic policy. Its impact was especially great on those academic economists who came of age (and influence) during the mid-

1970s. These even included the group of rising young economists know as "New Keynesians," the most famous of whom was Lawrence Summers, who went on to become an economic advisor to the Democratic Party and later served as Treasury Secretary in the Clinton administration. (Summers was recently chosen to be the new president of Harvard University.)

The New Keynesians held to the basic beliefs of the old Keynesians – namely that the government should intervene in the economy, especially to avoid the kind of economy-

wide market failures that lead to recessions. In light of the Lucas Critique, however, they had much more modest expectations of what government policy – especially fiscal policy – could accomplish.

Thinking in academia was also influenced by events in the 1960s and 1970s. The Kennedy tax cut, for instance, was formulated in the wake of the 1960 recession and formally proposed in 1962 – but didn't go into effect until 1964, when the economy was already well into recovery. When Lyndon Johnson sought to raise taxes to stop the inflationary spiral in 1966, the change proved to be too little, too late, and the boom was followed by a classic bust in 1970. The inability of government policy to prevent the recessions of 1970 and 1974, and the seeming inability of policy to cope with the frightening new phenomena of stagflation that characterized the 1970s, finished the job that the Lucas Critique had started: a chastened mainstream economics profession lost faith in the efficacy of countercyclical Keynesian fiscal policy.

### THE REAGAN REVOLUTION

The second reason for the turnaround of the political parties' views on deficits, surpluses and the balanced budget was political, and was due to the influence of Ronald Reagan. While Reagan ran on a platform of balancing the budget and continued to call on Congress to cut spending throughout his presidency, his first priority was, in fact, to cut taxes. Close behind were his twin goals of increasing military spending and reducing discretionary domestic spending. With help from opportunistic Democrats he succeeded in pushing through a major tax cut – restraining the growth of federal revenues – and was successful in boosting military spending. But he was much less successful in cutting other spending. In addition, the back-to-back recessions of 1980-1982 had the effect of reducing tax receipts and increasing non-discretionary spending for things like unemployment insurance and welfare. The net result was budget deficits far larger than the United States had even seen in peacetime – deficits in the hundreds of billions of dollars that, in the memorable phrase of the budget director, David Stockman, appeared to stretch forward "as far as the eye can see."

The political effect was two-fold. First, by 1986, the budget deficit – $221 billion that year – was perceived as a crisis, bemoaned by economists, business leaders and politicians of every stripe, even eliciting criticism from international organizations and allied nations unaccustomed to lecturing Washington on matters economic. Controlling the deficit became a key concern of voters in both political parties. The matter-of-fact view of the average voter (which harkened back to the Republican view of the 1950s) was, "If I have to balance my budget, why shouldn't the government?" The groundswell of public disfavor led, among other things, to the passage of the Gramm-Rudman-Hollings Act, designed to force Congress to keep deficit spending down.

The other political effect was less obvious, but equally important. In the 1960s and 1970s, those who were in favor of balancing the budget – typically Republicans – were mainly concerned with cutting federal spending, especially the social welfare spending that had begun to grow so rapidly as a result of the Johnson and Nixon administrations' initiatives, such as enhanced welfare payments and food stamps. For Democrats, to oppose the balanced budget – to argue that deficits were a lesser evil – was to defend liberal social priorities.

But once Reagan made tax cutting his priority and the massive deficits of the 1980s

were a reality, favoring the balanced budget could just as easily mean opposing the Reagan tax cut and favoring a return to higher pre-Reagan tax rates as a way to preserve federal spending. By the same token, opposing the balanced budget – or at least not actively seeking it – became, for some Republicans, a way of preserving low tax rates. Indeed, that policy stance was embraced by the new generation of Reagan Republican supply-siders.

Meanwhile, demographics were fundamentally changing the nature of the debate. Throughout the 1960s, as the giant baby boom generation entered the work force while the number of Americans reaching retirement age remained relatively small, there was little anxiety that government tax revenue would be inadequate to fund government spending. But in the 1980s, as the boomers reluctantly glimpsed the handwriting on the wall and the number of young people entering the work force dwindled, it became increasingly hard to ignore that by the early 21st century, the government would be hard-pressed to honor its promises to retirees.

Academic economists began examining the long-term effects of deficit finance, and a new consensus began to form that took the long view on fiscal policy. Reflecting the disfavor into which old-fashioned Keynesianism had fallen, there was now virtually no support for actively using deficit financing to stimulate the economy. New Keynesians and the conservatives influenced by rational-expectations theory converged on the view that keeping the budget in rough balance – perhaps even running surpluses when economic times were good – was good policy.

By the time the George Bush *pere* Administration took office in 1989, controlling the deficit was the number-one political priority – espoused, for different reasons, by politicians in both parties. Elite academics buttressed this conclusion. "The consensus is shifting," Lawrence Summers, then the youngest member of the Harvard faculty ever to be granted tenure, explained in 1990. Summers and his peers favored a balanced budget and a surplus in the Social Security accounts to reflect the need to reduce its actuarial deficit.

Edward Gramlich (then a public-finance economist at the University of Michigan and now a governor at the Federal Reserve Board) went further. "Something like three-quarters of the profession would support the goal of a surplus," he said.

The Bush budget for the 1991 fiscal year aimed for balance by 1993 and then to build surpluses throughout the 1990s earmarked for reducing the national debt. Bush's chief economist, Michael Boskin of Stanford, had no illusions that this would be an easy task. "It will take a lot of political acumen, as well as economic wisdom, to move in this direction," he said in early 1990. "But we think it is a tremendously important change."

Even though the idea of balancing the budget had become politically and economically respectable by 1990, Bush's plan to accumulate large budget surpluses still seemed unrealistic to many. "I don't believe it," said Charles L. Schultze, a Brookings Institution economist who had served in the Carter White House. "The Administration has been making promises to Congress for years, promising a balanced budget, but has never done anything." And the supply-side true believers made clear there would be a fight to get from here to there: an editorial in *The Wall Street Journal* in early 1990 sniffed that "envisioning budget surpluses requires a heroic suspension of disbelief."

Later that year, George Bush took a big step toward making his own projections come true by signing the Budget Enforcement Act of 1990, which included a tax increase. The

law set the nation on a path toward fiscal responsibility. But when Bush lost the 1992 election to Bill Clinton, it seemed likely that policy again would stray from the path of fiscal righteousness. One of Clinton's first proposals after taking office in 1993 was a fiscal-stimulus package that included increased government spending designed to move the economy out of the recession that had started in 1990. (Ironically, it later became clear that the recession ended in 1991 and that the economy was well on the mend by the time the 1992 election took place.)

But Congress voted the stimulus package down, and Clinton, apprised of the fact that the recession was truly over, changed course by embracing the idea of balancing the budget. "Clinton basically wasn't trusted to be fiscally responsible," recalls Robert Reischauer. But his advisers – Alice Rivlin, Leon Panetta and Robert Rubin – convinced him that he had to impose a dose of fiscal restraint in the form of the 1993 budget act.

"At that point, the medicine began to work," says Reischauer. "The economy began to grow, the unemployment rate began to fall, and the rest is history. It was like sitting on a toboggan and enjoying the ride." Reischauer gives credit to the 1990 and 1993 budget acts, to the willingness of the Federal Reserve to maintain an accommodative monetary policy as the budgetary restraint took hold, and to pure dumb luck. "The three of those things coming together," he says, "produced a transformation of our fiscal situation that was nothing short of spectacular."

### THE POLITICS OF SURPLUS

The next inflection point for fiscal policy – and the third factor in fiscal role reversal – came in 1997, when the total federal budget, including the Social Security accounts, moved into surplus. "The issue," explained William Gale, an economist at The Brookings Institution, "was whether the Clinton Administration would declare victory and take the surplus and spend it, or whether they'd hold out and go for an on-budget surplus. People like me wanted them to hold out, but it was unclear whether there would be the political will to do it. It turned out that the economy was so strong that it was easy."

There was also a question in 1997 whether the surplus would tempt the Republicans, who controlled Congress, to push for a tax cut. By standing firm for an on-budget surplus, the Clinton administration maintained the high ground in the debate, and headed off the Republicans' attempts to cut taxes.

The role reversal that had begun in the Reagan years was now complete: The Democrats were solidly behind the idea of a budget surplus because it had become the best way to protect government revenues. The Republicans were now against the idea of letting budget surpluses accumulate, because to do so forestalled the possibility of cutting taxes.

An editorial in *The New York Times* in 1999 noted that: "only a few years ago, the idea of Congress and the President wrangling over a trillion-dollar budget surplus would have provoked disbelief." But that's precisely where the policy debate wound up in the 2000 presidential election, and where it remains in 2001. The Bush administration has proposed a tax cut that would devote nearly all the surpluses over the next decade to reducing taxes. The Democrats, while bowing to the political fact that cutting taxes is always popular – and has special power right now due to the weakness of the United States economy – are seeking to preserve as much of the surplus as they can by limiting the size of the tax cut.

Who says political economy has to be dull – or predictable?