Back to the '80s Big budget deficits are back. Whether they sink or support the U.S. economy remains to be seen.
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By Mark Gongloff, CNN/Money Staff Writer

NEW YORK (CNN/Money) - Skinny ties, feathered hair and legwarmers may not be coming back -- hopefully -- but at least one hallmark of the 1980s is here again: big budget deficits that could endanger the government's fiscal future, even if they help the economy in the short run.

The White House released a budget proposal Monday that projects deficits from 2003 to 2008 totaling some $1.4 trillion, including shortfalls in 2003 and 2004 that would be the biggest relative to gross domestic product (GDP) since the 1980s and early 1990s.

Though Democrats are crying loud and long about what they call the president's fiscal irresponsibility, President Bush and many economists say deficit spending is tolerable -- desirable, even -- when the economy is as anemic as it has been since early 2001.

"When the economy is running below potential, I don't mind deficits at all," said Rajeev Dhawan, director of the Economic Forecasting Center at Georgia State University's Robinson College of Business.

Bush argues his tax cuts, the majority of which will benefit businesses and upper-income families, will spur investment, thus boosting gross domestic product. Faster economic growth, this theory goes, will make Americans wealthier, driving up tax revenue and improving the budget picture.

"It's generally the case that if you push through tax cuts, over time, it will stimulate activity; and as growth accelerates, you'll start to get revenue increases back," said James Padinha, economic strategist at Arnhold & S. Bleichroeder.

Will it work this time?

This theory has been called many names: trickle-down, supply side and even "voodoo economics" (by Bush's father), and it's been called even worse -- names that are unprintable -- by Democrats.

Whether this actually works is hotly debated by conservatives -- who say the supply side approach of the Reagan years set the stage for the boom of the late 1980s -- and liberals, who
say it does nothing for the economy and wrecks the budget in the process.

In a note published Wednesday on the Morgan Stanley Web site, chief economist Stephen Roach cited a 1998 study by the Congressional Budget Office (CBO) that showed the impact of various tax hikes and tax cuts on government revenue in the 1980s and 1990s.

One of the most famous of these programs, the Economic Recovery Tax Act of 1981, proposed by President Reagan, bears some resemblance to Bush's economic stimulus plan.

Both plans were presented as muscular horses to pull the economy out of the muck. Both involved cutting all sorts of taxes for all sorts of individuals and corporations, while also encouraging different forms of individual saving.

After the 1981 tax cuts took effect, the CBO cut its estimate of tax revenue for 1982-87 by $294 billion. But tax receipts were actually $205 billion lower during those years than the CBO's already reduced estimates -- numbers that might have been even worse if some of the 1981 tax cuts weren't reversed by Congress in 1982, the CBO said.

Part of that additional shortfall was due to the effects of the 1981-82 recession, but the 1982-87 revenue drop is the kind of thing that makes some economists say the "trickle-down" theory is a load of bunk.

"Like it or not, the experience of the 1980s demonstrates that supply-side tax cuts are not self-financing," Morgan Stanley chief economist Stephen Roach wrote in a research note. "In my opinion, similar results can be expected from the multi-year tax cuts now on the table in Washington."

Some economists also think the kind of tax cuts Bush proposes will do little to help the economy in the short term anyway, since wealthier Americans are less likely to spend the extra money they'll get, and businesses will want to wait for economic improvement before they have an incentive to invest.

"If you want to really help the economy right away, the fastest way to do that is to have the government spend the money itself," said Sung Won Sohn, chief economist at Wells Fargo & Co. "The next step would be to give tax cuts to low- and middle-income people, who are more likely to spend the money."

On the other hand, if the president's tax cuts, including elimination of the dividend tax, spur higher stock prices, that will be a boon to the shaky confidence of businesses and consumers - especially seniors, who rely heavily on dividend income -- which could encourage more spending in the short run.

**Will Frankenstein’s monster wreck the budget?**

The Democrats have offered their own stimulus plan, with smaller tax cuts, different spending projects and grants to cash-strapped state and local governments, whose budget problems could be a serious drag on the economy, offsetting much of the stimulus the federal government offers.

All this has yet to be fully debated, and after much grandstanding in Congress, the resulting
stimulus package will probably include elements of both parties' plans. So a multibillion-dollar Frankenstein's monster of tax cuts and spending plans could stumble out of Congress this summer -- right about the time most economists think the economy could be picking up steam post-Iraq.

In other words, the budget might have been sacrificed to fix an economy that was already being fixed -- remember the Federal Reserve has cut interest rates to the lowest in 40 years in a bid to spur growth -- though a small number of economists think the economy could be in bad shape for a while.

"The tax cuts are being proposed as permanent cuts," noted Ken Goldstein, an economist with the Conference Board, a private research firm that publishes a monthly survey of consumer confidence. "This proposal is a permanent change, even if the economy should go back to the growth we had" before the recession.

Meanwhile, the White House's budget projections don't include the possible cost of war in Iraq or a prolonged occupation of Iraq, if such a thing is necessary, or any additional spending on the space program arising from the shuttle disaster.

If Bush and the supply siders are right -- if increased economic activity boosts government revenue and fixes the budget -- then there shouldn't be any problem.

But if they're wrong, the budget deficit could be ballooning at right about the time millions of Baby Boomers are getting ready to retire and start drawing Social Security benefits.

"Down the road, there are significant consequences in terms of what could be developing with the federal budget," Goldstein said.

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