Quick Study

A Policy Report Summary by the Institute for Policy Innovation

# On the Origins and Persistence of Federal Budget Deficits Since 1980

**A Summary of IPI Policy Report #141**

By Lawrence A. Hunter

In 1981, President Ronald Reagan signed into law a sweeping package of "supply-side" tax rate reductions designed to reverse the "stagflation" (simultaneous inflation and economic stagnation) inherited from President Carter. The tax cuts were to be phased in through 1983.

Almost immediately, the political opponents of Ronald Reagan and the intellectual foes of supply-side economics began a relentless propaganda campaign to discredit supply-side policies. There were two basic lines of attack. The first thrust was to deny that there were any beneficial effects of supply-side policies or to insist that these benefits were vastly overstated.

The second, complementary thrust was to blame federal budget deficits on the 1981 tax cuts. This paper refutes this second critique of the Reagan supply-side tax cuts.

After enactment of the 1981 tax cuts, the supply-side critics successfully transformed their propaganda into conventional wisdom inside the Washington beltway, and the Congress was moved within a year to truncate the scheduled tax cuts before they were fully implemented. What began as unfounded conventional wisdom in the 1980s assumed mythic proportions in the 1990s, even among many conservatives.

*In reality, out-of-control deficits were created when, subsequent to passage of the 1981 tax reductions, Congress dramatically increased government spending.*

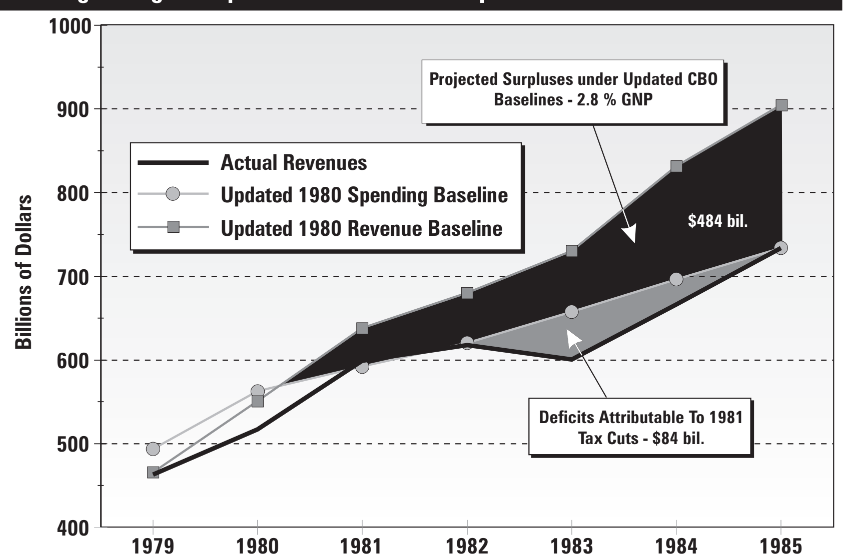
## Background

Before the phase-in of the 1981 income tax cuts began—indeed before Ronald Reagan even took the oath of office—the accumulated weight of high taxes and extraordinarily tight monetary policy had begun to take their toll on the economy and the deficit. "Real," inflation-adjusted economic output declined at an annual rate of 10 percent in the second quarter of 1980, marking it as an official recession year. As a result, between 1979 and 1980, the federal budget deficit jumped by almost two-thirds when measured as a share of output, going from 1.7 percent of gross domestic product (GDP) to 2.8 percent.

Inflation-adjusted output continued to shrink in five of the next eight quarters so that by the end of 1982, the real economy was a full three

**Figure 1**

**Large Budget Surpluses Loomed Under Updated 1980 CBO Baselines**



percent smaller than the day Ronald Reagan assumed office. Not surprisingly, the federal budget deficit continued to balloon as the recession rolled on, jumping another 75 percent between 1980 and 1982, from $73.4 billion to $128 billion.

By 1983, the deficit had quadrupled over the level of 1979, hitting $208 billion, or 6.3 percent of GDP. The 1983 deficit was larger relative to the total economy than any deficit had been since 1947 and, as it turned out later, larger than at any time since then. Barely more than one-quarter of the deficit eruption in 1983 was caused by the Reagan supply-side tax rate reductions, and virtually none of the persistent deficits in subsequent years resulted from the Reagan tax cuts. In order to see this fact clearly, one must take as a vantage point the year before the Reagan tax cuts were enacted.

## The View From 1980

In 1980, the Congressional Budget Office (CBO) projected that the federal budget would be $96 billion in *surplus* in 1983. Over the five-year period, 1981-1985, CBO projected cumulative budget *surpluses* of $578 billion, or 3.2 percent of GNP.

By 1983, not only had the recessionary economy shrunk during the preceding three years of recession, but inflation also had collapsed, falling more than five percentage points beneath the rate CBO had forecast. As a result of recession and reduced inflation, 1983 revenues under pre-1981 tax law would have fallen $50 billion short of the revenue projections CBO made in 1980. From 1983 to 1985, updated baseline revenues under pre-1981 tax rates would have been reduced from CBO's original estimate by a total of $271 billion due exclusively to the recession and lower inflation.

The important fact to note is that even though the size of the economy was some 1.2 percent smaller in 1983 than anticipated in 1980, and even though inflation collapsed thereafter, the updated CBO baselines reveal that under pre-1981 law, huge budget surpluses still would have persisted as far as the eye could see under pre-1981 tax rates. [See Figure 1.] And the 1981 tax cuts did little more than offset the expected budget surpluses. Had spending been restrained to increase just fast enough to keep entitlement spending in line with inflation and demographic changes, the budget would have been in balance in 1985. In fact, by 1985, the 1981 tax cuts contributed absolutely nothing to the deficit. *The entire deficit by 1985 was a product of drastically increased spending.* [See Figure 2.]

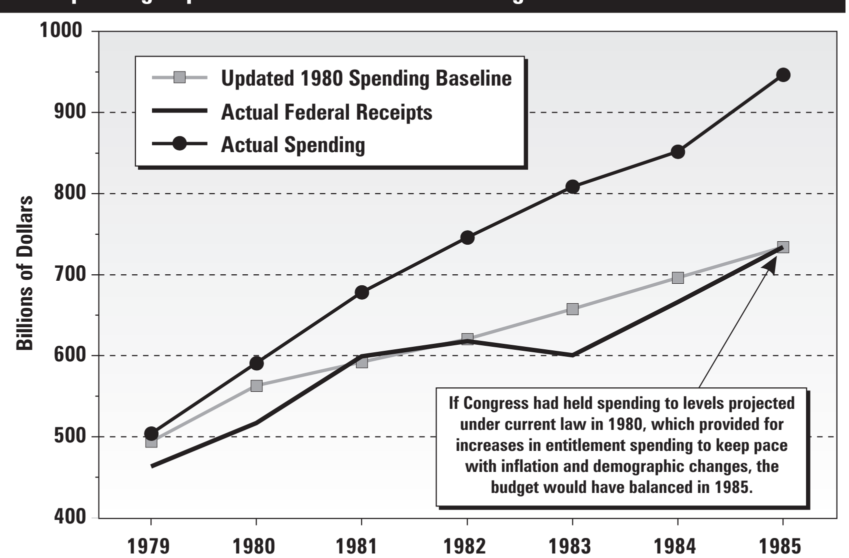
After the 1981 tax cuts were enacted, spending increases shot above and beyond levels already provided for in law to accommodate inflation and demographic changes. In 1983, the deficit hit $208 billion, or 6 percent of GNP. In short, even after taking into account a smaller economy, less inflation and the full impact of the 1981 tax cuts, the 1983 deficit would have been less than $60 billion, or 1.7 percent of GNP, had spending not accelerated.

Rather than the 1981 tax cuts, it was the sudden collapse of Jimmy Carter's inflation and dramatic increases in federal spending subsequent to the tax cuts that sparked the deficit explosion between 1979 and 1983. **In other words, it is not even necessary to demonstrate that supply-side economics worked as advertised to prove that the origins and persistence of federal budget deficits since 1980 are not attributable to the 1981 tax cuts.**

After 1983, the Reagan tax cuts worked as advertised, and the economy began to grow robustly. Consequently, the budget deficit began to decline as a share of GDP. By 1989 when Ronald Reagan left office, after "seven fat years" of economic prosperity, the deficit was back down to 2.9 percent of GDP, almost exactly the same share of GDP comprised by the deficit the day he assumed office in 1981 (2.7 percent).

**Figure 2**

**Spending Explosion Prevents Balanced Budget under 1981 Tax Cuts**



## The Making Of A Myth

> ***"The great enemy of the truth is very often not the lie—deliberate, contrived and dishonest—but the myth—persistent, persuasive and unrealistic."***
> **—John F. Kennedy**

An accurate accounting for America's deficit problem must begin with CBO's 1980 revenue and spending baselines. The idea behind baselines is to give policy makers some notion of what would happen to revenue and expenditure patterns if current tax and spending laws were left unchanged. Baselines are subject to error in part because they are dependent upon the accuracy of the economic assumptions that drive them.

The roots of the myth that the 1981 tax cuts blew a hole in the federal budget deficit depend upon accepting as realistic these unlikely implications of the 1980 baselines:

- Real economic growth would average 3.8 percent a year and annual inflation would average about 10 percent for the 1980-1985 period *without tax cuts.*
- Revenues would grow from 20.1 percent of GNP in 1979 to 24 percent of GNP in 1985 *without tax cuts.*
- Spending would *decline* to 17.3 percent of GNP in 1985, allowing entitlement spending to keep pace with inflation and demographic changes.

And, therefore:

- Budget surpluses under current (1980) law would accumulate to $578 billion or 3.2 percent of total GNP for the period 1981–1985, with a single year surplus of $290 billion or 6.5 percent of GNP in 1985.

While the critics of supply side economics stubbornly cling to the revenue baseline as the appropriate benchmark, an examination of those baselines shows a quite different conclusion: 1980 tax law was economically and politically unsustainable.

CBO's 1980 revenue baseline was economically dubious. The economic logic behind CBO's 1980 auto-pilot projection of revenue growth is internally inconsistent. The CBO report acknowledged that "without a tax cut … the increased tax burden under current law would reach an unprecedented level, constituting a significant fiscal drag on the economy." Nevertheless, CBO assumed that the economy would grow on an inflation-adjusted basis between 1982 and 1985 at 3.8 percent, a rate "slightly higher than the post-war average." CBO offered no plausible explanation that the staggering economy would spontaneously shake off stagflation and zoom to above-average rates of growth.

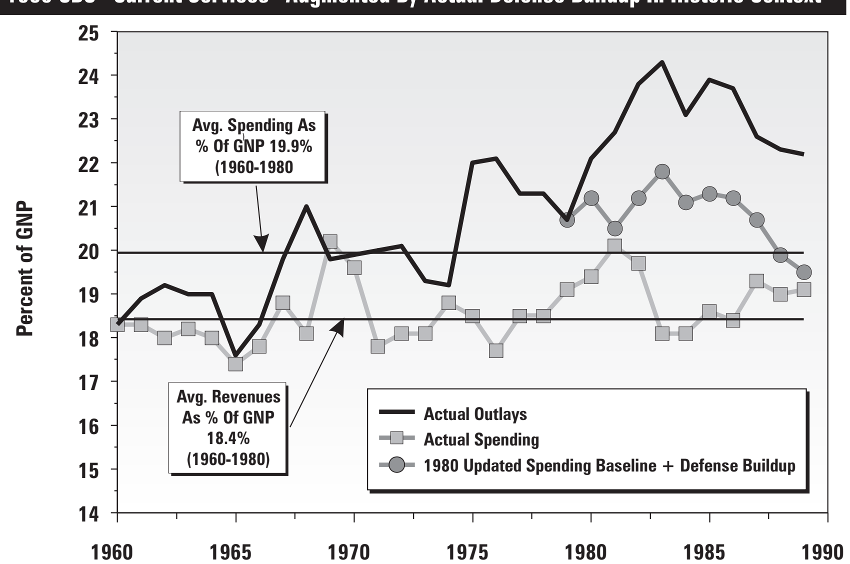
The 1980 CBO revenue baseline was politically dubious as well. CBO itself acknowledged that revenue growth projected was well outside the range that American voters and the Congress had been willing to tolerate historically. CBO observed that "in the past, the Congress has enacted income tax cuts that have, in fact, offset the effects of inflation on the progressive tax structure, as well as stimulated economic growth." The report noted that Congress had cut taxes in 1964, 1969, 1971, 1975, 1976, 1977 and 1978. CBO concluded that without a tax cut that "individual income taxes would rise to … the highest levels in history."

The key to the success of the myth makers was their ability to establish a growth path for revenues similar to the 1980 CBO baseline. The deficit would be attributed to the so-called "revenue shortfall" from this economically questionable and politically preposterous baseline.

The myth requires one to believe that with the economy slumping and inflation pushing tax burdens to unprecedented levels, the American people would gladly permit, and the economy would readily accommodate, the accumulation of enormous budget surpluses.

**Figure 3**

**1980 CBO "Current Services" Augmented By Actual Defense Buildup In Historic Context**



## What About Defense Spending?

During the final confrontation with Communism, the nation underwent a significant military buildup that was not incorporated in CBO's 1980 spending projections. When the critics of supply side economics are confronted with incontrovertible evidence that the 1981 tax cuts did not explode the deficit, they invariably point to this jump in defense spending as the co-villain in the deficit saga. Again, the facts belie these assertions.

What would have happened under the 1981 tax cuts with a complete defense build-up, assuming that entitlement spending increased sufficiently to keep pace with inflation and demographic changes, is that deficits would have been cut in half through 1985, and the budget would have come into balance by the end of the decade. [See Figure 3]

## Conclusion

British author Edward de Bono has observed that "a myth is a fixed way of looking at the world which cannot be destroyed because, looked at through the myth, all evidence supports that myth." This truth is most aptly illustrated by the myth that the 1981 tax cuts were responsible for large persistent federal budget deficits. On the basis of this myth, more than 500 economists from across the country signed their name to a statement opposing 1996 Republican Presidential challenger Robert Dole's proposed 15 percent across-the-board tax rate reductions. As the sage is reported to have said, "it's not what we don't know that hurts us so much as all those things we know so well that just aren't true." Never did a cliche apply to a situation more aptly than to Ronald Reagan's supply-side tax cuts of 1981.


IPI Quick Study

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Publisher . . . . . . . . . Tom Giovanetti
Editor . . . . . . . . . . . . Gary Kinman

IPI **Quick Study** is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.





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### Want More Info?

This study is a summary of IPI Policy Report # 141, *On the Origins and Persistence of Federal Budget Deficits Since 1980.*

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