As a Budget Storm Gathers, Bush Ignores Fiscal Forecast

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Ever since the Bush Administration came to office in January 2001, it has repeatedly expressed overly optimistic views of the future. No sooner are the sunny pronouncements out of their mouths, then disaster strikes. This may be the first president who bases the defense for his performance on all the bad things that have happened on his watch: The White House argument seems to be that it is doing surprisingly well once you take into account the 2001 recession, the September 11 terrorist attack, the breaching of the levies in New Orleans, and the quagmire in Iraq. Perhaps they also want credit for a long series of policy decisions that have turned out to have been ill-advised.

But it is not to the administration's credit that it has failed to consider in advance the downside contingencies of history. After September 11, the National Security Advisor said that nobody could have imagined that terrorists would take airplanes and fly them into buildings as missiles, apparently unaware that her own terrorism coordinator Richard Clarke, among others, had warned of precisely that. After no weapons of mass destruction were found in Iraq, the Administration said 'we were all wrong," even though many had in fact all along suspected that the intelligence was being cooked. After Hurricane Katrina, President Bush said that nobody could have imagined that the dikes around New Orleans would breach, apparently unaware that many experts had warned of precisely that.

The same pattern applies to economic policy, particularly the budget deficit. From the beginning, the government forecasts of the budget have been predictably overly optimistic. Fiscal forecasting is as hard as forecasting the weather. But the bias has been so consistent that one must assume that the strategy was deliberate, so as to justify tax cuts. In January 2001, the government forecasted that the fiscal surpluses that had been inherited from the preceding administration would continue as far as the eye could see. Among other reasons for this, their forecast of the future economic growth rate did not allow for the likelihood that someday there would be a recession and a consequent decline in tax revenues. As luck would have it, the recession began two months later. (The Clinton Administration, by contrast, had erred on the conservative side, and had built the possibility of future recession into its forecasts.)

Already by August of 2001 the Bush Administration had given away so much money in tax cuts, without the positive effect on growth and revenues that had been predicted by supply side economics materializing, that professional forecasts showed that the surpluses were about to disappear. But most of the public had not yet noticed, and soon enough came September 11. The White House Administration was able to give the American public the impression that this tragedy was the source of the renewed budget deficits. Never mind that that the lost growth and tax revenue pre-dated September 11, rather than following it.

Meanwhile spending increased rapidly. Bush argued that the government needed to spend more to make us safe from terrorism. Never mind that he accelerated the growth rate of government spending in such domestic areas as farm subsidies, highways, and fossil fuels as much as in security-related spending, that pork spending hidden under the name of Homeland Security has disproportionately benefited Republican stronghold states like Wyoming rather than terrorist targets like New York, and that the military effort in Iraq has made us less safe rather than more.

Most of the post-9/11 budget forecasts, short-term as well as long-term, have been as overly optimistic as the original ones. (The one exception was the 2004 projection for what would happen in 2005.) They haven't allow for realistic projections of spending growth, nor for the costs of the (continuing) engagement in Iraq, nor for the ever-more-extensive tax cuts that the Administration continues to propose, nor for the agreed need to fix the Alternative Minimum Tax. Now we have on top of those sources of underestimates, the hundreds of billions of dollars to be spent atoning for the failures to prepare for, or deal promptly with, the consequences of, Katrina. It should be clear by now even to the White House forecasters that the budget deficits are not going away anytime soon. Yet they are still at it. The current forecast from the Office of Management and Budget is that the budget deficit will fall to $268 billion (2.1% of GDP) in 2006. But this won't happen, nor will it decline by half within five years as the President pledged in the campaign. At least the Congressional Budget Office's forecasts finally contain the admission that the deficit will not disappear within ten years, on current policies, even when the surplus in the Social Security trust funds is added in with the on-budget deficit. The official forecast is for a cumulated deficit of $2.1 trillion. But one must turn to sources such as the non-partisan Concord Coalition to read a more realistic baseline forecast: an ever-widening deficit that totals $ 5.7 trillion over the next ten years. (Concord Coalition has the level of the annual deficit approaching $900 billion in 2015, versus CBO's forecast which gets close to zero. The major differences are allowance for extension of expiring tax provisions and AMT relief, as the White House supports, together with more realistic projections for spending.)

Few people would disagree with the desirability of fiscal discipline: if budget deficits remain large in the long run they can be harmful to the economy, because they soak up available saving. But there is sharp disagreement about how to reduce US federal deficits. There are two competing views of political economy.

"*The Starve the Beast"* hypothesis was proclaimed by some in the Reagan Administration, after its tax cuts led to the emergence of record deficits. This proposition justifies tax cuts and budget deficits as a deliberate strategy to force Congress to cut spending. It is said that the government can't spend money it doesn't have. Many defenders of current Administration policy have advanced this claim again today. The alternative hypothesis could be called the approach of *"Shared Sacrifice."* It says the way to achieve budget balance is a regime where each faction agrees to restrain itself simultaneously. Congressmen each agree to forego their individual pet tax cuts and spending programs if the others do. This is the regime that was institutionalized in the Budget Enforcement Act negotiated by the first President Bush in 1990 and that was renewed by the Clinton budget of 1993: Legislated spending caps and rules said that anyone proposing new tax cuts would have to show how to pay for them.

The accompanying graph suggests pretty strongly that the Starve the Beast hypothesis is wrong: the budget deficits produced by the low-tax policies of 1981, 1989 and 2001 were accompanied by increased spending, not reduced spending. The fact is that Congress *can* spend money it does not have, and does so gleefully. Only after presidents have reversed their low-tax campaign platforms has progress been made at cutting both government spending and the deficit. In the 1990s, taxes were raised and at the same time spending cut as a share of GDP. It worked. By the end of the Clinton Administration surpluses were back for the first time in 30 years, and in fact reached record levels.

[FIGURE: Federal Spending and Budget Deficit as % of GDP]

George W. Bush followed his two Republican predecessors in beginning his term with aggressive low-tax policies, and rapid increases in spending. But the administrations of Ronald Reagan and George H.W. Bush at least had the ability to perceive when the sky began to cloud over. When fiscal reality began to deviate from the sunny scripts that had been written by their speechwriters, they made mid-course adjustments. Both presidents reversed themselves, and began to raise taxes soon after large deficits, which had been predicted by the pessimists, in fact emerged. Bush, Senior, deserved a medal for bravery, and of course paid a heavy price electorally for abandoning his “no new taxes” pledge. What is remarkable about his son is that there appears to be no feed-back loop from reality, no means of perceiving that things are not going as planned and that some sort of adjustment is called for. This management failure is a familiar story from Iraq policy, but it is equally true of fiscal policy. The Administration is still proposing tax cuts, perhaps still clinging to the Starve the Beast theory, even though it is at the same time raising spending as rapidly as ever. This is why an unbiased forecast shows widening budget deficits over the next ten years.

Why should we fear these budget deficits? It is true that so far the financial markets have tolerated them remarkably well. But some day soon, the bond market will catch up with reality, and will fall substantially. Rising long-term interest rates (and slowing house prices) will send millions of American households into default on their mortgages -- especially those with interest-only or Adjustable Rate Mortgages. President Bush will probably then say that nobody could have anticipated that either ! Or perhaps a different shock will hit first: foreign investors will tire of holding ever-greater amounts of dollar securities to fund the US current account deficit. In that case, the dollar will fall, interest rates again will rise, and we may be back to stagflation. We will no longer have the luxury of cutting taxes and interest rates as we go into the recession, as the government was able to do in 2001 because it had inherited low inflation and a strong budget after the long boom of the 1990s. Rather we will have to raise interest rates and taxes, as budget deficits and inflation forced the government to do after the booms of the 1960s, 1970s, and 1980s.

The President may marvel that no one could have foreseen such things. But risks such as financial bubble-burstings, recessions, terrorist attacks, oil price increases, and hurricanes need to be planned for ahead of time. The less adequate is the forward planning for disaster contingencies, the bigger is the cost of cleaning up the mess on the day after.

Source: *Budget of the United States Government*, FY 2006.