

The Political Economy of the Emerging U.S. Fiscal Crisis

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## ABSTRACT

The United States suffered a severe financial crisis in September of 2008, the effects of which are still strongly reverberating throughout the national economy and the finances of American government. While the financial downturn greatly exacerbated the nation's immediate fiscal stress, government policies have played a large role in the longer-term economic challenges. The buildup of financial insecurity for individuals and businesses since the 1970s, brought to painfully emphatic clarity by the 2008 financial crash, has citizens of all political persuasions deeply concerned about the future of the Republic. This thesis attempts to explain the historical context which is indispensable to understanding the significance of our current fiscal challenges. In doing so, we come to the conclusion that rising entitlement spending, coupled with severe problems within the nation's tax system, have become the primary drivers of the significant fiscal stress that is building. I argue that the most immediately viable option for reversing this trend, in a way that supports economic opportunity for all, is to implement fundamental tax reform to lift the current system's burdens of complication, inefficiency, and inequity off the shoulders of American taxpayers and businesses.

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## Chapter One: Introduction and Theoretical Framework

The past four decades have represented a time of increasing financial insecurity for the U.S. citizenry. Flattening wages and overall work compensation, increasingly volatile job markets, and tremendous strains on public finances brought on by erosions in tax bases at every level of government, have all combined to increase the financial burdens of working Americans. Consequently, a great many citizens have had to save less money and go deeper into debt. This essential breakdown has resulted in the strong sense of insecurity that has been mounting and which gripped the citizenry in full in the wake of the financial crash of 2008. The fallout from this crash has manifested in a “great recession” which precipitated record losses in personal savings and property, high unemployment, severe hesitation for bank lending, plummeting tax revenues while government spending obligations have increased, and a general sense of anxiety about what the future of the country will entail.

Within this overall process, this study focuses on the tremendous stress currently imperiling the nation’s public finances at the federal level of government. Whereas the 2008 financial crisis has obviously exacerbated this fiscal stress at the present time, the larger picture is the impact of federal taxation, spending patterns, and monetary policy on market outcomes and personal financial well-being. Grappling with these large macroeconomic questions requires a discerning look at our national fiscal and economic history. In doing so, we come to the clear discovery that the U.S. is now on an unsustainable fiscal path, as current tax revenues are not sufficient to cover the expenses which the government is obligated by law to provide. In this thesis, I show that this unsustainable fiscal path is driven by increasing government health and social insurance costs and the unnecessary complications, inefficiencies, and inequities of a tax system which is not

producing revenues sufficient to cover the expanded spending obligations, and which has become overly burdensome on working Americans. As a result of these factors, I argue that the best immediate option to put America on a fiscally sustainable path is to reform the tax code through eliminating loopholes and tax preferences, thereby broadening the revenue base and curtailing the corporate and special interest lobbying power and economic distortions which are aggrandized by the system's current complexities.

In light of this current fiscal stress and the high likelihood of its exacerbation well into the future, our empirical questions present as such: which policies and conditions have contributed most to placing the U.S. government on an unsustainable fiscal path, and in what ways specifically do these factors threaten the economic health of the nation?

These questions cannot be addressed without a long-run analysis of U.S. fiscal and economic history. Thus, chapter four provides a general look at this history so that we can fully understand the significance of our fiscal policies and economic indicators in 2011 and beyond. This historical focus places our interpretation of the consequences of U.S. fiscal policy within a path-dependent model, which states that present choices are constrained by past experience. This is not to deny that new eras can produce completely new types of challenges for which old remedies may not suffice; in fact, we will see even in this study that they do. Rather, this study maintains that our best reference points in addressing fiscal challenges are often the lessons taught by past experiences. In other words, history matters.

Through a methodology of secondary analysis, which attempts to synthesize the works of political writers from widely-varying perspectives, a guiding principle of this study is to cast an explanatory light on a fiscal problem for which the scope is well-known, but the underlying causes less clear. The differing viewpoints on these underlying causes provide the theoretical

framework through which this thesis attempts to clarify some of the debate surrounding U.S. fiscal policy in this difficult and uncertain time. This framework is the debate between the two major philosophies of 20<sup>th</sup> century U.S. political economy: Keynesianism and Reaganomics. As we will see, both of these philosophies arose as a result of the political-economic circumstances of their time, and a thorough analysis of U.S. fiscal history makes it obvious that neither will alone suffice in the effort to address the emerging fiscal crisis.

This secondary analysis also includes my interpretation of fiscal and economic data from government websites and many other sources spanning the thematically relevant books, academic journals, online newspapers, and other web information. The literature review, which formulates our third chapter, highlights eight books which are of particular theoretical relevance to the thesis topic. Many other books and articles throughout the intersection of politics, economics, history, and public policy are utilized as well, with the overriding goal of synthesis being to give due consideration to as many divergent perspectives and persuasive arguments on U.S. fiscal conditions as possible.

The chief measures of economic health- for the purposes of such a broad study- are the nation's Gross Domestic Product (GDP), economic growth or contraction in relation to GDP, unemployment rates, stock values and the business environment, average overall compensation for workers, personal wealth, and other measures specific to major sectors of the economy, such as in the housing and financial markets. Analysis of government finance pertains to fiscal conditions such as the characteristics of the tax structure, the amount and distribution of government expenditures, and levels of government deficits and accumulated debt. In this study, the national debt and many other key fiscal measures are gauged primarily by their size relative to GDP, rather than their absolute size- a method for which evaluation is completely independent

of the size of the economy, and thus insufficient for comparative analysis between different points in time.

In addressing such a large and complex topic in relatively brief fashion, it is necessary to briefly describe some key limitations to our analysis. There are undoubtedly several topics relevant to U.S. political economy which cannot be given adequate coverage in this study. Among these are the impacts of international trade agreements, organized labor, and federal regulation on fiscal conditions. Merely attempting to understand the big picture regarding tax and spend patterns is enough of a task; to branch out too far into these other related topics would be beyond the scope of this study. Furthermore, the great recession is only referenced insofar as it relates specifically to the broader analyses of historical spending and taxation. Therefore, the primary sphere of analysis for this thesis consists of two parts; first, the history of the most consequential portions of the U.S. federal budget- the taxes most important to drawing adequate revenues, and the very largest forms of government expenditure; and second, the relation of these fiscal policies (coupled with monetary policy) to the broader economy.

## Chapter Two: Financial Crash and Fiscal Stress

The historical significance of the 2008 financial crisis, and subsequent great recession, are both plain to see. According to the Bureau of Labor Statistics, the average unemployment rate for the year 2009 was 9.3 percent (for all U.S. workers 16 or older). With the exception of two yearly unemployment rates during the recession of the early 1980s (1982 and 1983), 2009 represented the highest yearly unemployment average in the U.S. in the post-World War II era, over 4 percentage points higher than the average of the decade preceding it.<sup>1</sup> Unemployment was still at 9.8 percent for the month of November 2010 (fully 26 months after the official outbreak of the financial crisis), indicating an uncommon degree of economic stagnation.<sup>2</sup>

Beyond the official unemployment rates, a due consideration of structural unemployment brings us to a more complete understanding of the financial crisis. Certainly a recognition of unemployed citizens who would fall into the natural unemployment rate (a controversial figure, but generally thought to be in the proximity of five percent of the working-age population) cuts into the unemployment percentage that we can reasonably gauge. That being said, the “under-employment” rate as of December 2010, which includes those who have given up looking for work and those working part-time jobs because full-time work is unavailable, has been estimated at 17.3 percent.<sup>3</sup>

The housing bubble and subsequent burst (which is generally pegged to 2006) opened the floodgates for a debt-fueled financial breakdown. By the time the effects of the financial crash of September 2008 could be compiled for analysis, statistical indicators within the housing market

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<sup>1</sup> Data.bls.gov, 12/15/10

<sup>2</sup> Goodman (1/8/10)

<sup>3</sup> Goodman (1/8/10)

pointed to a severe crisis. According to Realtytrac, there were nearly 4,000,000 reported foreclosure filings in 2009, of which 2.82 million properties were foreclosed. This number of foreclosures for 2009 represented a 21 percent increase from 2008 and a 120 percent increase from 2007. The percentage of all U.S. housing units included in at least one foreclosure filing nearly quadrupled from 2006 to 2009.<sup>4</sup> This erosion in the U.S. housing market has been stubbornly persistent. At the end of February 2011, the median price of all previously owned homes had fallen to \$156,100, the lowest total since 2002, and home purchases declined by 9.6 percent for the month.<sup>5</sup>

The financial crisis was rooted in the unsustainable rise of home values, and compounded by the leveraging of those home mortgages through derivatives trading. Consequently, the nation suffered a plummeting in personal wealth. The Federal Reserve reported that households lost \$5.1 trillion in wealth in the last three months of 2008 alone, the most ever for a single quarter in the 57 years of such record-keeping.<sup>6</sup> Furthermore, the psychological impact of losing one's home, perhaps severing ties with the surrounding community, and, for many people, not having the qualifications to market their skills for valuable employment in a new area, has made the collapse of the housing and financial markets devastating in a way which statistics cannot fully convey.

Economic growth has been stagnant in this period as well. In the four-quarter period beginning July 1, 2008 and ending June 30, 2009, the U.S. economy- measured in terms of GDP- shrank by a total of 16.4 percentage points.<sup>7</sup> GDP growth in the time since has been slow and given pause

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<sup>4</sup> Realtytrac.com, 12/12/10

<sup>5</sup> Blackden (3/21/11)

<sup>6</sup> Bajaj (3/12/09)

<sup>7</sup> Tradingeconomics.com, 12/14/10

to optimism for the economic horizon. Furthermore, as the federal stimulus funds continue to run out, concern regarding the lack of significant job creation becomes all the more acute.

These obvious indicators of the crisis which the U.S. has now suffered through for two and a half years bring up many questions which cannot all be addressed in this thesis. For our purposes, the most important aspect of the financial crisis of 2008 is the impact it has had on government budgets.

On the tax revenue side of the federal budget, the fallout from the financial crisis of 2008 has been quite significant. As a result of wealth loss, lower values for stocks, bonds, and real estate, and the negative impact of greater unemployment on income and payroll taxes, total tax revenue has unsurprisingly fallen. In regards to government spending outlays, during times of economic stagnation governments tend to increase spending on unemployment insurance and public works projects in order to lessen the damage created by the suffering economy. This scenario was no different in the aftermath of September 2008, as the federal government implemented a \$787 billion economic stimulus package and extended unemployment insurance first through the end of November 2010, and again into 2011. Furthermore, the U.S. government authorized the Treasury to spend up to \$700 billion on the Troubled Asset Relief Program (TARP) to help the financial sector weather the storm of the 2008 crisis. Thus, keeping in mind these extraordinary circumstances straining budgetary conditions over the past two and a half years, the rest of this chapter details the current state of public finance in the U.S.

Total outstanding public debt for the U.S., as of April 2011, exceeds \$14.29 trillion.<sup>8</sup> This figure does not differentiate between publicly-held debt and intragovernmental debt, as some debt forecasts do. According to the U.S. Treasury, intragovernmental debt is represented by certain government accounts such as government trust funds (i.e. Social Security), and currently this

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<sup>8</sup> Usdebtclock.org, 4/17/11, Treasurydirect.gov (4/21/11)

measure is approximately \$4.6 trillion.<sup>9</sup> These items only differ from the rest of the national debt (approximately \$9.6 trillion) in that they are bills for which the government is indebted to itself, rather than to other entities; they are still financial obligations which must be paid. The rest of the overall debt figure includes all general federal government debts held by individuals, corporations, state and local governments, foreign governments, and other entities outside of the U.S. federal government.<sup>10</sup>

The overall federal debt of \$14.29 trillion includes the accumulation of prior U.S. federal government budget deficits. This national debt figure represents 97 percent of U.S. GDP for 2010, which registered at \$14.62 trillion.<sup>11</sup> The national debt provides our first and most obvious example of why historical context is crucial to understanding the emerging fiscal crisis.

According to John Steele Gordon, “In the first 184 years of our independence, we took on a burden of debt of \$300 billion, mostly to fight the wars that made and preserved us a nation... In the last fifty [years], however, we have taken on more than thirty-six times as much new debt.”<sup>12</sup>

One may ask how this has happened, yet, the immediate answer is summed up just as well by Gordon: “In the 139 years encompassing the period 1792-1930, the federal government ran a surplus ninety-three times and a deficit forty-six times, a two-to-one ratio. In the eighty years since 1930, however, it has had a surplus in only eight of them and a deficit in seventy-one, almost a one-to-nine ratio.”<sup>13</sup>

Prior to the past two fiscal years, the federal budget had never exceeded \$412.7 billion in deficit, and for the years 1995 to 2008, spent four consecutive years in surplus and registered deficits of

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<sup>9</sup> Treasurydirect.gov, 12/12/10, Treasurydirect.gov (4/21/11)

<sup>10</sup> Treasurydirect.gov, 12/12/10

<sup>11</sup> Usgovernmentspending.com, 12/13/10

<sup>12</sup> Gordon (2010), p. 8

<sup>13</sup> Gordon (2010), p. 113

less than \$200 billion in an additional five years.<sup>14</sup> Yet, in fiscal years 2009 and 2010, deficits amounted to \$1.42 and \$1.29 *trillion*, respectively<sup>15</sup>, with the 2009 total reaching fully 10 percent of GDP. The national debt never reached 50 percent of GDP from 1965 to 1985, and never climbed to 70 percent at any time between then and 2008<sup>16</sup>; however, the debt currently stands at 97 percent of GDP, and this percentage will continue to climb in the absence of unlikely reductions in government spending or increases in tax revenue. Such an extreme shift in the direction of annual deficits and accumulated debt cannot represent anything less than a fundamental change in the dynamics of fiscal policymaking in Washington.

As the governments' annual ratio of revenue drawn to expenditures determines the budgetary balance, it is necessary to provide a brief description of current tax rates and amounts of public expenditure. As of 2008, the individual income tax comprised 45 percent of federal revenue, with payroll taxes on wages and salaries garnering 36 percent of total revenue, and the corporate income tax producing 12 percent of overall revenue<sup>17</sup>; as we will see, taxes on corporate income have accounted for an even smaller share of revenues since then. Taxes on capital gains and dividends are part of the income tax system.

Currently the personal income tax is comprised of six different brackets, ranging from the first \$8,375 earned being taxed at a rate of 10 percent (with a \$3,650 personal exemption), to all income above \$373,651 being taxed at the top marginal rate of 35 percent.<sup>18</sup> There are also many income tax deductions (including the standard deduction) for personal circumstances. The tax rate on corporate income is 35 percent. Capital gains income- those gains realized upon the sale of capital assets such as stocks, bonds and real estate- are currently taxed at a rate of 15 percent

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<sup>14</sup> Gordon (2010), p. 208

<sup>15</sup> Gao.gov (2010)

<sup>16</sup> Gordon (2010), p. 207-8

<sup>17</sup> Williams (4/22/09)

<sup>18</sup> Irs.gov, 12/13/10

for long-term gains, while the rate for short-term gains is matched with the taxpayers' corresponding income tax rate. Dividends, portions of corporate profits paid back to shareholders, are taxed in two categories as well: ordinary dividends at the rates matching individuals' income tax rate, and qualified dividends at a rate of 15 percent for all earners in the 25 percent income tax bracket or higher, and 0 percent for all earners in lower income tax brackets.<sup>19</sup>

The Federal Insurance Contributions Act (FICA), or payroll, tax, applies to the wage and salary earnings of nearly all workers in the U.S. 6.2 percent of such individual earnings up to the \$106,800 limit are taxed in order to fund the Social Security insurance program, with an identical 6.2 percent earnings contribution from the employer for every employee creating a 12.4 percent total Social Security tax on all such wage and salary earnings. Additionally, the payroll tax includes identical 1.45 percent levies on wage and salary income from both employee and employer, creating a 2.9 percent total tax which funds a portion of Medicare. Thus, the total combined FICA tax rate is currently 15.3 percent.

The priorities, composition, and impacts of U.S. federal government spending represent such a complex and voluminous topic that it would take many studies to adequately explain it all. However, in this thesis we can delineate the most central functions of federal spending, how these spending patterns have changed over time, and what their story indicates about the fiscal and economic state of the U.S. in 2011.

The budgeted federal spending for fiscal year 2011 is \$3.819 trillion. Of this total, 25 percent is devoted to national defense, 23 percent to health care, 21 percent to pensions, 13 percent to welfare, and 18 percent for all additional spending.<sup>20</sup> The result of this composition is that over

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<sup>19</sup> Irs.gov, 12/13/10

<sup>20</sup> Chantrill, 4/23/11

half of the budget is devoted to mandatory spending<sup>21</sup>, expenditures made automatically through previous law and not subject to annual appropriations like the rest of the budget. The current composition of mandatory spending is 37 percent for Social Security, 23 percent for Medicare, 15 percent for Medicaid and other health programs, 8 percent for unemployment compensation, and 16 percent for additional program expenditures.<sup>22</sup> The Congressional Budget Office estimates the 2011 federal budget deficit to be \$1.5 trillion<sup>23</sup>, which would be the highest nominal deficit in U.S. history. As this deficit is expected to reach at least 10 percent of GDP, by this measure- excepting brief deficit spikes to fund the two World Wars, and the 2009 and 2010 deficits which were likewise victims of the current crisis- it would tower over all previous annual budget deficits since the turn of the 20<sup>th</sup> century.<sup>24</sup> Total state and local debt is approximately \$2.4 trillion, or 15 percent of GDP.<sup>25</sup>

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<sup>21</sup> CBO (March 2011, p. 9)

<sup>22</sup> CBO (March 2011, p. 12)

<sup>23</sup> Cbsnews.com (1/26/11)

<sup>24</sup> Chantrill, 2/29/11

<sup>25</sup> Mufson (2/20/11)

## Chapter Three: Literature Review

As the causes and effects of the U.S. governments' financial strains are the central concern of this thesis, one of our foundational books provides a concise historical examination of the relation between federal tax rates and revenues, government spending behavior, and the political forces behind fiscal policy: economic historian John Steele Gordon's *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt* (2010). Gordon helps make sense of the nation's fiscal record by explaining the causes of deficits and debt throughout U.S. history, which in turn provides a clear context for the significance of our current fiscal stress and the high level of spending obligations- relative to the quite modest tax revenue production- we have committed to ourselves for the future.

From this big-picture analysis of U.S. fiscal policy, one central lesson stands out: the major fiscal trend of our modern era is one of increasingly frequent and severe federal budget deficits, which have of course driven the national debt to a historically high level. For Gordon, tax-code complexity and lack of adequate revenue production<sup>1</sup>- and their insulation within the exigencies of political campaign funding<sup>2</sup>- have combined with a loosening of Congressional budget rules<sup>3</sup> and increased entitlement obligations to create a wholly unsustainable budgetary balance.

The role of tax policy in this emerging crisis is certainly the central theme of *The End of Prosperity: How Higher Taxes Will Doom the Economy- If We Let It Happen* (2008), by economists Arthur Laffer, Stephen Moore, and business executive Peter Tanous. Laffer et al. provide a detailed look at the effects of federal tax rates and structures on economic growth.

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<sup>1</sup> Gordon (2010), p. 193

<sup>2</sup> Gordon (2010), p. 150

<sup>3</sup> Gordon (2010), p. 147-50

Similarly to Gordon, Laffer et al. emphasize the incentives of businesses and individuals to invest and take the risks that fuel economic growth<sup>4</sup>, and from this emphasis warn against the drive to raise tax rates and further complicate our tax system in the desire to attain greater revenues. For the authors of *The End of Prosperity*, the way out of America's financial woes is through tax cuts combined with fundamental reform of the tax code to curtail its great complication and waste<sup>5</sup>. Additionally, the authors posit that a tight monetary policy arising in tandem with such tax reform will have the most beneficial impact on the economy, and that through all of these coinciding factors, the resulting economic growth would be sufficient to produce revenues equal to the government's expected outlays.

Indeed, monetary policy is an indispensable part of the modern economic story according to journalist Robert Samuelson in *The Great Inflation And Its Aftermath: The Past and Future of American Affluence* (2008). Samuelson ably chronicles the high inflation and eventual "stagflation" of the 1970s, exposing the monetary roots of the problem and describing the efforts of the Paul Volcker-led Federal Reserve, in both the Carter and Reagan administrations, to halt and reverse this inflation. The rest of U.S. fiscal and economic history- the last three decades- can thus be best understood as the after-effects of this historical achievement to reverse the nation's worst modern inflationary spiral<sup>6</sup>, a thesis which describes this recent time period as a massive disinflation with varying consequences, but mostly positive.<sup>7</sup>

For the authors of each of these first three works, the primary interpretation of U.S. fiscal policy is in its relation to business and individual incentive. Furthermore, Gordon, Bartlett, and Laffer et al. all provide evidence of failures to improve the economy and budgetary balance through

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<sup>4</sup> Laffer et al. (2008), p. 36

<sup>5</sup> Laffer et al. (2008), p. 243-244

<sup>6</sup> Samuelson (2008), p. 140

<sup>7</sup> Samuelson (2008), p. 136

increased tax rates or major public works spending. While there are significant differences between these authors, especially where Laffer et al. clearly take the limited government philosophy to a much greater extent than the others, each author generally falls into the “business incentive” interpretation of the role of government. In sum, the tax reduction, monetary restriction, and market deregulation of the early 1980s which have had such an undeniable impact on the U.S. economy in the time since, have all been largely approved by this interpretation.

Yet, there is also a valuable literature which opposes this interpretation. The essence of the other philosophical side of our literature review is the larger political impact of the post-1980 American economy, which has not been all positive, and which certainly cannot be explained solely in terms of economic efficiency. At the forefront of this perspective are economist/columnist Paul Krugman, lawyer and former Labor Secretary Robert Reich, and political scientists Jacob Hacker and Paul Pierson.

In *The Conscience of a Liberal* (2007), Krugman examines the origins of economic inequality in the U.S. from a largely political standpoint. In what we will see is a common interpretation, Krugman forwards the idea of an arc development in U.S. economic history of high income inequality, then relative equality, then high inequality again. The “Long Gilded Age” of the 1880s through the Great Depression represents the first era, a time of an expanding industrial economy where the very few reaped unheard-of benefits at the expense of the many. This period gave way to Franklin Roosevelt’s New Deal and the eventual prosperity, much more widely-shared, which lasted from the end of World War II until the mid-1970s. The most recent era then represents a return to the economic inequality of the Long Gilded Age, as the legacy of supply-side economics has ushered in a new era of high inequality and financial insecurity for many.

Central to this interpretation is the role of government in influencing market outcomes. Krugman challenges the conventional economic wisdom that “Impersonal forces such as technological change and globalization caused America’s income distribution to become increasingly unequal”, and instead posits that “the inequality of the Gilded Age to the relative equality of the postwar era wasn’t a gradual evolution. Instead, America’s postwar middle-class society was created, in just the space of a few years, by the policies of the Roosevelt administration.”<sup>8</sup>

Krugman takes this as evidence that “institutions, norms, and the political environment matter a lot more for the distribution of income- and that impersonal market forces matter a lot less- than Economics 101 might lead you to believe.”<sup>9</sup>

Reich sounds a similar tone in both *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (2007), and *Aftershock: The Next Economy and America’s Future* (2010). In the former, Reich distinguishes this recent U.S. history from the mid-1970s to the present as reflective of two very different and simultaneous trends: while Americans have benefited tremendously as consumers and investors, we have also suffered great losses in the average value of our work compensation and the strength of our communities.

The modern and globalized production, distribution, and large retailer-sale of so many of the essential goods we consume (strongly affected by the aforementioned monetary policies and deregulation of the early 1980s) have provided great gains in the form of low costs and a proliferation of the amount and variety of products at our disposal.<sup>10</sup> However, where we have gained in these areas, Reich posits that we have suffered equivalent losses in our capacity as workers and citizens. This has manifested in flattening wages and work benefits<sup>11</sup>, erosion of tax

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<sup>8</sup> Krugman (2007), p. 7

<sup>9</sup> Krugman (2007), p. 8

<sup>10</sup> Reich (2007), p. 5

<sup>11</sup> Reich (2007), p. 106

revenue at a time of rising expenditure for much-needed public investment, and the damaging effects of enhanced capital mobility on our communities.

In *Aftershock*, Reich addresses the economic inequality issue more explicitly, arguing that the central ill in this current hour of financial turmoil is inadequate middle-class purchasing power. As a result of the flattening median income since the mid-1970s, the majority of Americans have had to go deeper into debt in order to keep up with “their reasonable expectations for what they could afford as the economy grew.”<sup>12</sup> The plummeting personal savings rate<sup>13</sup>, and increased average work hours and multiple-job workers<sup>14</sup>, indicate that most Americans have had to work harder for fewer earnings, and this in turn has forced them to rely on the unsustainable rise of home prices for building asset value, which of course played a big part in the financial crisis of 2008. Ultimately, Reich’s primary argument is that “Unless America’s middle-class receives a fair share, it cannot consume nearly what the nation is capable of producing, at least without going deeply into debt... The inevitable result is slower economic growth and an economy increasingly susceptible to great booms and terrible busts.”<sup>15</sup>

Lastly, Hacker and Pierson’s *Winner-Take-All Politics: How Washington Made the Rich Richer- And Turned Its Back on the Middle Class* (2010), takes the most direct and comprehensive aim at the exacerbation of economic inequality in this recent era. For Hacker and Pierson, Washington has turned its back on the large majority of Americans in two ways. First is the “drift” problem, a concept popularized by Walter Lippmann in the Progressive Era and defined by Hacker and Pierson as “the failure of government to respond to new economic realities.”<sup>16</sup> Many of the examples of drift result from the refusal of key legislators to close loopholes that benefit

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<sup>12</sup> Reich (2010), p. 42

<sup>13</sup> Reich (2010), p. 23

<sup>14</sup> Reich (2010), p. 61-62

<sup>15</sup> Reich (2010), p. 127

<sup>16</sup> Hacker and Pierson (2010), p. 83, Lippmann (1914), p. 36-37

powerful interests, even when laws no longer adequately apply to the situation at hand or when their continuation serves no purpose to the broader public.

Secondly, and very much intertwined with the institutionalization of drift, are the deliberate tax and other preferences provided to these most well-funded interests whose campaign funding is indispensable to those seeking to maintain high political office. In the wake of this cutthroat world of political expediency and all the policy clout that money can buy, the broad interests of the American people are left with no adequate spokesperson in Washington, thus explaining much of the widening inequality and other societal ills which have marked the modern era.

The reason that these seven books are of such interest to our study is that they are recent analyses which reflect one of the two major philosophies within our theoretical framework. Gordon, Samuelson, and especially Laffer et al., all largely argue for the reduced tax burdens, deregulation, and monetary restraint so critical to Reaganomics; while Krugman, Reich, and Hacker and Pierson fully champion the domestic demand concerns of Keynesian economics, which posits that large public investment and an expansive money supply are indispensable prescriptions when there are perceived shortages in such domestic demand. Ultimately, what is at stake in the contest between these two philosophies is the very role of government.

Yet, there is an additional book which puts an uncommon twist on this ultimate debate of modern U.S. political economy. Historian and economist Bruce Bartlett forwards a fascinating view of the development of opposing philosophies in the direction of modern U.S. fiscal policy in *The New American Economy: The Failure of Reaganomics and a New Way Forward* (2009). Instead of depicting the national economic debate merely as a contest of merits between those who favor a significant role for the government in promoting macroeconomic health and those who think it best for the government to be as limited as possible, Bartlett views the epochs of the

post-depression “Keynesian consensus”, and the post-stagflation ascendance of Reaganomics, as reflective of the challenges of their time, with neither approach suitable to every economic challenge which has arisen.

With the depression challenging many views on the very survival of the American political-economic system, large deficit spending- first on public works and later to fund and equip the nation’s World War II effort- and the attendant use of an expansive monetary policy to help bolster private demand (all central to Keynes’ arguments on addressing the deflationary conditions of the depression), were affirmed in the eyes of many when the U.S. emerged stronger than ever after the war<sup>17</sup>. However, as this perspective became a consensus in the ensuing decades- regardless of the nature of any given economic slowdown- politicians and bureaucrats grew to be naively convinced that the economy could be tinkered with and managed effectively by the government at all times<sup>18</sup>. When the difficult obstacle of “stagflation” emerged in the 1970s- a state of both high inflation and high unemployment which Keynesian management of the economy was supposed to render virtually impossible- the previously dominant faith in Keynesian economics unraveled and the nation came to require new economic theories.<sup>19</sup> Into the void stepped Reaganomics, with its preaching of the stimulative effects of tax cuts and a restrictive monetary policy, which were deemed to enhance national savings, investment, and thus economic growth to a degree which would eventually drive down interest rates and even result in increased tax revenues.<sup>20</sup> Some aspects of this philosophy are on the periphery of economic thought, and Bartlett himself came to criticize its weaknesses (hence the title of the book); however, what cannot be denied is the remarkable curbing of inflation under the actions

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<sup>17</sup> Bartlett (2009), p. 57

<sup>18</sup> Bartlett (2009), p. 70, 86-89

<sup>19</sup> Bartlett (2009), p. 96-97

<sup>20</sup> Bartlett (2009), p. 100

of the Volcker-led Federal Reserve, which was aided by Reagan's willingness to suffer higher unemployment for the short-term. This disinflation combined with significant tax reform would go on to benefit the American economy in the subsequent time period.

However, just as Keynesianism had been relied on too much in the 1970s, so were the supply-side ideals of Reaganomics in the post-1980 ascendance of American conservatism.<sup>21</sup> The large budget deficits of the 1980s, conservative Republican Congressional takeover of the 1990s, and fiscal and economic upheaval of the 2000s, were all driven by what has been termed the "starve the beast" mentality: major tax cuts will force the government to spend less, thereby sharply limiting its role in the economy while assisting deficit reduction. Bartlett posits that this was a greatly mistaken assumption, where such tax cuts did nothing to slow the growth of government spending and even produced greater tax burdens because of the tremendous increases in the national debt resulting from the high deficits of the 1980s and 2000s.<sup>22</sup>

Of all these differing viewpoints on key factors relating to America's fiscal and economic challenges, Bartlett's thesis is perhaps the most theoretically intriguing for the purposes of this study. Gordon's *Hamilton's Blessing* provides a thorough and balanced look at the nation's budgetary history; Samuelson illuminates, in *The Great Inflation*, an economic phenomenon which is not invoked enough in our contemporary political-economic debate, and does much to better inform it; and Krugman, Reich, Hacker and Pierson admirably take on a three-decade epoch of financial insecurity, for which Laffer et al.'s own admission to the post-1980 exacerbation of economic inequality<sup>23</sup> is quite a testament.

However, one time-tested lesson that we will learn from the annals of American history, chronicled in chapter four, is that of limits: limits to the theories that we have a tendency to ride

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<sup>21</sup> Bartlett (2009), p. 140-141

<sup>22</sup> Bartlett (2009), p. 160

<sup>23</sup> Laffer et al. (2008), p. 40

too far, and imposed by the changing circumstances of an increasingly complex economy and the unintended consequences usually accompanied by governmental attempts to alter it. By chronicling both the rise and the reality check of our national experiences with Keynesianism and Reaganomics, Bartlett wisely urges us to look towards the next macroeconomic solutions, rather than remaining bitterly mired in the worn-out debate of the past.

## Chapter Four: The History of the U.S. Federal Budget

The story of U.S. government fiscal policy goes back to the time of the nation's founding and the economic ideas of the first Treasury Secretary, Alexander Hamilton. According to Gordon, "Hamilton wanted to use the national debt to create a larger and more flexible money supply. Banks holding government bonds, he argued, could issue bank notes backed by them. He knew also that government bonds could serve as collateral for bank loans, multiplying the available capital, and that they would attract still more capital from Europe."<sup>1</sup> This plan to proactively incur a larger national debt in order to prove the willingness to borrow and amass credit, and to greatly expand capital flow and bolster the domestic economy, was facilitated by the First Bank of the United States, a centerpiece of Hamilton's ambitious economic program. This process was further aided by Hamilton's assumption plan, whereby the new federal government incurred the Revolutionary War debts of all the states.

There were constitutional concerns over the creation of the national bank, and sectional concerns over the assumption of the state war debts; in fact, then-Secretary of State Thomas Jefferson and Congressman James Madison led a burgeoning opposition to the Federalist Party led by Hamilton. However, in this early and uncertain moment of American history, Hamilton's unique understanding of international commerce and the dynamics behind public credit served the young nation well. According to Gordon, "In the 1780s the U.S. had been a financial basket case. By 1794 it had the highest credit rating in Europe... By 1801 Europeans held \$33 million in U.S. securities, and European capital was helping mightily to build the American economy."<sup>2</sup>

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<sup>1</sup> Gordon (2010), p. 26

<sup>2</sup> Gordon (2010), p. 36

The general nature of U.S. fiscal and economic policy did not change as much in the 19<sup>th</sup> century as it would in the subsequent time period. One event that does stand out is Wall Street's first great financial crash, the panic of 1837. As part of a lengthy and ultimately successful struggle to end the Second Bank of the U.S. in the 1830s, President Andrew Jackson precipitated a drawdown of the banks' holdings to be distributed to smaller "pet" banks within the states, and through this process ended up eradicating the entire national debt for the only time U.S. history. Yet, the law of unintended consequences soon made itself clear. The suddenly enriched smaller banks, which no longer had to contend with the national perspective and disciplinary requirements of a federal bank, began to rapidly increase the bank notes in circulation.<sup>3</sup> This development was supplemented by major speculation in western lands, resulting quickly in high inflation. Jackson was alarmed by this process and eventually, while Congress was adjourned, ordered the Specie Circular, requiring payments to the government for public lands to be made in gold and silver (with some limited exceptions). As Gordon explains, this caused "a greatly increased demand for specie in the West, draining the East of much of its supply of precious metal... it also caused land prices to fall sharply from their recent inflated highs, and this caused many defaults on bank loans collateralized by land".<sup>4</sup> The end result of this episode was a stock market crash in April of 1837 (occurring, conveniently for Jackson, one month after he left office) which ushered in a depression that represented "the most protracted period of continuous economic contraction in American history, one that lasted fully seventy-two months."<sup>5</sup> Thus, an all-out crusade against debt, paper money, and the inflation they were believed to be unnecessarily propagating, backfired and created the longest period of continuous economic

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<sup>3</sup> Gordon (2010), p. 57

<sup>4</sup> Gordon (2010), p. 59

<sup>5</sup> Gordon (2010), p. 59

decline in U.S. history. By the end of this ordeal, the national debt had grown roughly 100 times over, from \$337,000 in 1836 to \$32,743,000 in 1843.<sup>6</sup>

Beyond the panic of 1837, the major fiscal record of the 19<sup>th</sup> century is fairly straightforward. Tariffs on foreign goods, excise taxes, and government land sales provided the bulk of federal revenues, and budget deficits were almost always a result of either war or financial crises. The general tension in national economic debate was between northern industrial interests and southern agrarian interests. The former benefited from the large role of tariffs in fiscal policy, while the latter pushed for freer trade to capitalize on the production of cotton and other goods. However, all of these factors completely changed in the 20<sup>th</sup> century. Land sales were bound to become more and more obsolete, as the earth is indeed a finite space. And whereas tariff and excise taxes still accounted for over 90 percent of federal revenues in 1910, they now account for less than 10 percent.<sup>7</sup> The big change was the sudden and stunning ascendance of the income tax. During the beginnings of these changes in the dynamics of tax revenue production, the personal income tax was created through the 16<sup>th</sup> amendment to the Constitution, and was officially adopted in 1913. Previous judicial precedents regarding taxes had reinforced a constitutional ban on direct taxes unless they were apportioned to the states on the basis of population, not income.<sup>8</sup> However, the direct income tax on individuals was proposed as an amendment to the constitution by President William Taft (presumably under the assumption that it could never pass state ratification), then ended up victorious in the process, and impervious to a judicial check. Thus, the period from 1913 to the present represents the modern U.S. fiscal era, as tax rates on corporate income, capital gains, and dividends also became part of the new income tax system. Additionally, this year saw the creation of the Federal Reserve, the nation's first central bank

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<sup>6</sup> Gordon (2010), p. 204

<sup>7</sup> Gordon (2010), p. 98

<sup>8</sup> Gordon (2010), p. 81

since the downfall of the Second Bank of the U.S. at the hands of Andrew Jackson. The rest of this chapter is devoted to understanding the fiscal record of this last century, the lessons of which are most relevant to addressing our emerging fiscal crisis.

The first great increase in the national debt in this modern era occurred from FY 1917 to 1918, as the debt level rose from 4.93 percent to 16.3 percent of GDP.<sup>9</sup> This was of course due to the First World War, which prompted a rise in the newly-minted income tax (top marginal rate) to 73 percent, up from just 7 percent at its inception. After the war, the Harding and Coolidge administrations enacted a succession of tax cuts which brought the top income tax rate down from 73 percent in 1921 to 25 percent in 1925. Some of the results of this reform were astounding.

As a result of the 1920s tax cuts, according to Gordon, “revenue from the personal income tax did not fall. Indeed, it rose from \$690 million in 1921 to \$711 million five years later.”<sup>10</sup>

According to a Tax Foundation Report, “As the tax rates were chopped by almost two-thirds, the share of taxes paid by those earning over \$50,000 [quite a large income in those days] rose from 45% in 1921... to 62% in 1925... Those who made more than \$100,000 a year saw their tax share rise from 28% to 51%.”<sup>11</sup> Additionally, and resulting from many other coinciding factors, federal debt as a percentage of GDP declined from 34.45 percent in 1921 to 16.42 percent in 1929, dropping by more than half.<sup>12</sup>

There were a number of factors which greatly assisted these budgetary achievements in the 1920s. For one, federal spending was cut by 50 percent between 1920 and 1927<sup>13</sup>, a fact which is inseparable from the great debt reduction of this time. Secondly, the instantaneous skyrocketing

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<sup>9</sup> Gordon (2010), p. 206

<sup>10</sup> Gordon (2010), p. 104

<sup>11</sup> Tax Foundation (1982), Laffer et al. (2008)

<sup>12</sup> Gordon (2010), p. 206

<sup>13</sup> Gordon (2010), p. 203

of top income tax rates during World War I prompted many taxpayers in these brackets to find ways to shelter their income from a tax burden which they found unjustified<sup>14</sup>, and which, at the time, was wholly new and unexpected. Once top income rates were sharply reduced in the early 1920s, there was much less incentive to shelter income, and thus, assets were invested and put to productive use, widening the tax base and helping bolster the economy. As we will see, this example has often been used erroneously to justify high-income tax cuts in any economic environment, regardless of the level of tax rates at that point in time. Four facts about the 1920s tax environment show why this is a mistaken assumption.

For one, the post-war boom began before the tax cuts, and this economic growth greatly aided revenues. Secondly, income tax rates were extremely high at this time, with the top marginal rate being 73 percent before the tax reductions of the 1920s. Considering that this was an increase from a rate of just 7 percent only a few years before, those in the upper-income brackets were understandably shocked to face such a daunting tax burden. Thus, the stimulative potential of decreasing taxes from a rate of 73 percent was far greater than what it would be in the event of a reduction in our current top income rate of 35 percent. A third factor is that investment at this time was mostly confined to the domestic economy. Therefore, when reduced tax burdens alleviated the previous degree of tax avoidance and profit sheltering, the newly-bolstered tax compliance and financial investment had much larger direct impacts on the American economy and tax base than they would in later periods.

Lastly, at the inception of the income tax, only the top two percent of income earners were subject to pay it<sup>15</sup>, and even after World War I only the wealthiest five percent of the citizenry

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<sup>14</sup> Smiley (Oct. 1996)

<sup>15</sup> Barlett and Steele (1994), p. 61

were subject to the income tax<sup>16</sup>; therefore, once the unprecedentedly high tax rates of the War era were reduced in the 1920s, and the irresistible urge to shelter income and avoid taxation was thus greatly curtailed, there suddenly was a great portion of the nation's income no longer hidden from taxation. In other words, with only the very wealthiest Americans subject to the income tax, federal revenues were far more dependent on the tax compliance of these individuals than they would ever be at later periods in our history. Thus, when the reduction of such high-income tax rates provided tremendous incentive for both greater compliance with tax obligations and larger investment of capital, the result was greater revenues and economic growth. This development occurred in tandem with the general post-war boom, bolstering a prosperity which played out for the rest of the decade and marking it as a time we will always remember for surging economic growth but high income inequality.<sup>17</sup>

The Great Depression then developed in the aftermath of the stock market crash of 1929, and had an obviously detrimental impact on the U.S. federal budget. Many works in the political-economic literature point to Federal Reserve monetary policy as a major factor in explaining the causes of the stock market crash of 1929. With stock market speculation raging in the late 1920s, Federal Reserve board members and other close onlookers began to worry that a major speculative bubble was ballooning, and that monetary policy should be used to “cool down” this speculation. Thus, under the leadership of New York Fed board chairman Benjamin Strong, the Fed began tightening the money supply in 1928 through increasing the discount rate at which member banks could borrow money. However, when Strong died later in the year, it appears that this still-young central banking system was ill-prepared to handle the increased role and pressure

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<sup>16</sup> Barlett and Steele (1994), p. 61-62

<sup>17</sup> Reich (2010), p. 19-20

which its power now entailed. As a result, the Fed refused to act until it was too late, and the speculation on Wall Street marched on until the bubble burst in October of 1929.<sup>18</sup>

That this financial crisis played a big part in the deepest and longest economic downturn in U.S. history is clear. However, the role that government policy played in the aftermath of the crash, and the degree to which these policies exacerbated the crisis, is often not recognized. According to many economists, including John Maynard Keynes, the most crucial policy mistakes were the tax rate increases of 1932 and the increased tariffs of the Smoot-Hawley Act of 1930, all signed into law by President Herbert Hoover.<sup>19</sup>

Originally intended by its Congressional sponsors as a bill to support American agriculture, the Smoot-Hawley Tariff Act of 1930 generated protectionist calls from all industrial quarters, and resulted in an increase in overall U.S. tariff rates<sup>20</sup> which historically were only rivaled by those of the famous- or infamous- “tariff of abominations” in 1828 (which led to the Nullification Crisis in South Carolina). This policy effectively set off a storm of retaliatory tariff hikes from many of the world’s major economies. As a result, U.S. imports from Europe declined from \$1.3 billion in 1929 to just \$390 million in 1932, and U.S. exports to Europe fell from \$2.3 billion in 1929 to just \$784 million in 1932.<sup>21</sup> Total world trade declined by 66 percent between 1929 and 1934.<sup>22</sup>

Additionally, the Hoover administration enacted the Revenue Act of 1932, raising the top income tax rate from 25 percent to 63 percent, doubling the estate tax, significantly increasing the corporate income tax, and even instituted a tax on all bank checks. Whatever the rationale was for this major tax hike in a time of economic turmoil, it did not produce the revenues that its

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<sup>18</sup> Gordon (2010), p. 108

<sup>19</sup> Laffer et al. (2008), p. 53, Bartlett (2009), p. 49. Gordon (2010), p. 110

<sup>20</sup> State.gov, 1/27/11

<sup>21</sup> State.gov, 1/27/11

<sup>22</sup> State.gov, 3/16/11

supporters used to claim justification for its enactment. From 1932 to 1934, the federal deficit increased by nearly \$1 billion from \$2.73 billion to \$3.63 billion, and the debt increased from 33 percent to 41 percent of GDP.<sup>23</sup> By the time of Franklin Roosevelt's inauguration in 1933, the U.S. GNP had decreased from \$103.8 billion in 1929 to just \$55.7 billion, one-third of non-agricultural workers were unemployed, and total unemployment had reached 25 percent- eight times the unemployment rate of 3.2 percent at the onset of the crash of 1929.<sup>24</sup>

The Roosevelt administration then began instituting its New Deal vision of a government with a far more active role in the nation's economy than at any time prior to the depression era. For the purpose of brevity, the fiscal record of the Roosevelt administration can be viewed as two distinct periods: the pre-World War II years of Roosevelt's first two terms (1933 to 1941), and the war years which took up the remainder of his presidency and his years on this earth (1942 to 1945). Policy efforts in the first period were characterized by the essence of New Deal hopes and desires; direct government involvement in the economy in the form of wage and price controls, subsidies, public works spending, and greater regulation of commerce. Then the later war period featured a military mobilization and campaign unlike any the world has ever witnessed, an effort which of course could not come cheap.

The most ambitious fiscal initiative of Roosevelt's tenure (a competitive acclamation, to be sure) was the National Recovery Administration, implemented by the National Industrial Recovery Act of 1933, which sought to establish across-the-board wage and price controls for major American industries.<sup>25</sup> However, this program was declared unconstitutional by a unanimous Supreme Court vote in 1935. The Roosevelt administration also greatly bolstered the realm of

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<sup>23</sup> Gordon (2010), p. 206

<sup>24</sup> Nps.gov, 3/18/11

<sup>25</sup> Reich (2007), p. 26

independent regulatory agencies, including the creation of the Securities and Exchange Commission and the Federal Communications Commission.

The major fiscal impact of this first era in Roosevelt's tenure was the increased spending through public works programs, designed to stimulate job-growth in a time of depression. According to Gordon, "Federal spending more than doubled between 1933 and 1940, from \$4.6 billion to \$9.6 billion, with very little increase in military spending."<sup>26</sup> In attempting to pay for all of this domestic investment, the Revenue Act of 1935 raised the top personal income tax rate to 79 percent, the top corporate tax rate to 40 percent, and increased the estate tax.<sup>27</sup> Annual deficits still remained high in this period, and the national debt increased from 40.5 percent of GDP in 1933 to 50.8 percent of GDP in 1940. However, these years were characterized by so much economic deprivation that greater government revenues probably could not have been expected. Additionally, evidence suggests that Roosevelt did not embrace the Keynesian philosophy- that of deficit-financing during times of economic stagnation- to a great enough extent to actively pursue large deficits, until the recession of 1937-1938 called into question the effectiveness of his fiscal program up to that point.<sup>28</sup>

Despite a period of significant GDP growth in the mid-1930s, unemployment averaged more than 17 percent between 1933 and 1941, and was still at a historically sky-high level of 14.6 percent in 1940, nearly two full terms into Roosevelt's presidency.<sup>29</sup> However, it should be noted that these unemployment figures do not include short-term work relief employment in the Works Progress Administration (WPA), which helped address the painful conditions of the depression after its 1935 enactment. The most effective reforms of the New Deal era were the long-term

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<sup>26</sup> Gordon (2010), p. 115

<sup>27</sup> Truthandpolitics.org 2/27/11, Gordon (2010), p. 116

<sup>28</sup> Bartlett (2009), p. 54

<sup>29</sup> Laffer et al. (2008), p. 54 (with data from bls.gov)

legacies of Social Security (enacted in 1937, and funded by the first payroll tax in U.S. history), and the Federal Deposit Insurance Corporation, which was created by the first Glass-Steagall Act and greatly aided the return of public confidence in the nation's banks. Additionally, Glass-Steagall established the separation of commercial and investment banking, the breakdown and eventual abolition of which affected the financial crash of 2008. Ultimately, according to many economists and others, it was the U.S. effort in World War II which finally pulled the country out of depression.<sup>30</sup>

The budgetary impact of waging war in this instance was truly remarkable, but certainly expected given the military challenge and consequences involved. Defense spending, which reached a post-World War I low of just 1.25 percent of GDP in the 1920s, rose to an astronomical 42 percent of GDP by 1945.<sup>31</sup> And the drawdown from the Second World War was equally impressive, as military spending dropped to 3.5 percent of GDP by 1948.<sup>32</sup> Between 1940 and 1943 the federal deficit grew by 27 times, from \$2.17 billion to \$54.77 billion.<sup>33</sup> From 1941 to 1946, the national debt increased from 46.18 percent to 129.98 percent of GDP. Eventually the top income tax rate would be raised to 91 percent<sup>34</sup>, an extreme rate which signals the severity of the debt challenge at this time.

Washington fiscal policy remained fairly unified in the early post-World War II era. Throughout the presidencies of Democrat Harry Truman and Republican Dwight Eisenhower, there was a relative consensus in Congress and the White House regarding budgetary priorities and the taxes requisite to paying for them. Eisenhower did not attempt to roll back the established precedents of the New Deal, and signed into law the Federal-Aid Highway Act of 1956, appropriating \$25

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<sup>30</sup> Bartlett (2009), p. 57

<sup>31</sup> Chantrill, 3/19/11

<sup>32</sup> Truthandpolitics.org, 3/12/11

<sup>33</sup> Gordon (2010), p. 206

<sup>34</sup> Hyperhistory.com, 3/17/11

billion to jump-start the nation's interstate system.<sup>35</sup> After peaking again at 15 percent of GDP during the Korean War in 1953, defense spending dropped to roughly 10 percent of GDP for the rest of the 1950s and 1960s, and through the end of the Viet Nam war.<sup>36</sup>

With decreases in defense spending, continually declining debt, and coming off the heels of the recession of 1958-1959, the new administration of President John F. Kennedy in the early 1960s sought to lower the overall tax burden for the purpose of stimulating the economy. After Kennedy had publicly urged for significant cuts in both income and investment taxes<sup>37</sup>, the Revenue Act of 1964, passed just shortly after Kennedy's tragic assassination, reduced the top marginal income tax rate from 91 to 70 percent, and reduced the corporate tax rate from 52 to 48 percent.

As was the case with the tax cuts of the 1920s, the results of the 1964 tax reform were impressive. According to Arthur Okun, economic advisor to President Lyndon Johnson, these tax cuts were responsible for a \$25 billion contribution to GNP by mid-1965, and ultimately increased GNP by \$36 billion.<sup>38</sup> According to a 1982 report by the Joint Economic Committee (JEC), "Americans earning over \$50,000 per year (the equivalent of about \$200,000 today) increased their taxes by nearly 40 percent after the rate cut. Their tax share rose from 12 percent of the total in 1963 to almost 15 percent in 1966. Americans with an income of more than \$1 million nearly doubled their tax payments, from \$311 million in 1962 when the tax rate was 91 percent to \$603 million in 1965 when the tax rate was 70 percent."<sup>39</sup> Yet perhaps most importantly, IRS data show that tax revenues from personal and corporate income increased by an 8.6 percent yearly average between 1965 and 1968, after just a 2.1 percent annual rate of

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<sup>35</sup> Nationalatlas.gov, 3/15/11

<sup>36</sup> Chantrill, 3/18/11

<sup>37</sup> Laffer et al. (2008), p. 56

<sup>38</sup> Laffer et al. (2008), p. 58

<sup>39</sup> Joint Economic Committee (6/18/82), Laffer et al. (2008), p. 58

increase between 1961 and 1964. Whereas this revenue total was \$63.5 billion in the year of Kennedy's inauguration (1961), by 1968 it had risen to \$95.7 billion.<sup>40</sup>

Both the revenue increases and economic growth were again produced largely by the tremendous financial incentives resulting from reductions in punitive income tax rates, which in this case included a reduction in the top marginal income rate from 91 to 70 percent. Yet once again, mirroring the fiscal reform of the 1920s, the great debt reduction in the 1960s would not have been possible without a restraint on the spending side of the budget arising in tandem with tax rate reductions. In the five-year period between 1960 and 1965, federal spending increased by a modest 28.4 percent; however, in the three following five-year periods (1965 to 1970, 1970 to 1975, and 1975 to 1980) the spending increases jumped to 66 percent, 69 percent, and 77.8 percent, respectively.<sup>41</sup> Thus, the federal debt unsurprisingly decreased in the aftermath of the Revenue Act of 1964, mostly because of the reform of the tax structure and the spending restraint championed by its key inspiration, President Kennedy. The debt dropped by a third from 1960 to 1970, decreasing from 57.75 percent of GDP to 39.16 percent.<sup>42</sup>

On the domestic front, it can certainly be argued that 1965 was one of the biggest years of positive change in our nation's history. This year saw President Lyndon Johnson sign both the the Elementary and Secondary Education Act (ESEA), establishing major federal funding for the nation's school system for the first time, and the Social Security Act of 1965, which created Medicare and Medicaid. While these programs obviously would come to represent a substantial portion of the federal budget, the returns on the investment are incalculable. And as a result of the booming 1960s economy, the national debt continued to decline in the latter part of the decade. Even through the protracted U.S. military efforts in Viet Nam and large increases in

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<sup>40</sup> Laffer et al. (2008), p. 59

<sup>41</sup> Gordon (2010), p. 207

<sup>42</sup> Gordon (2010), p. 207

domestic spending, the debt steadily declined to the range of 35 percent of GDP, where it remained from 1973 until 1982.<sup>43</sup> Although this 1970s debt level represented a post-depression low, we will see that it was not a result of fiscal restraint.

In fact, the role of a growing Social Security program in the federal budget in the late 1960s provided a glimpse of the imprudent fiscal policy that, unfortunately, was soon to become business-as-usual in the nation's capital. After suffering the largest post-World War II deficit in 1967<sup>44</sup>, the Johnson administration came to the realization that increasing funding for both the Viet Nam War and the Great Society domestic initiatives, while still preventing large deficits, was not possible under the budgetary provisions then in force. Thus, rather than face the unattractive options of either raising taxes or reducing spending, the administration successfully proposed to make the Social Security and other trust funds "on-budget", meaning that they were now to be included with general revenues for budgetary calculations. The growing Social Security surpluses in the late 1960s made this an attractive modification to the budget, and for a brief time gave the appearance of greater budgetary balance.<sup>45</sup>

However, the government's expenditures continued to mount, and after this accounting change helped produce a budget surplus in 1969<sup>46</sup>, even the newly-"unified" budget including huge infusions of Social Security cash would not suffice in the effort to mask the underlying realities of maintaining such large government expenditure. After 1969, the federal budget would be in deficit every single year until the late 1990s.<sup>47</sup>

The remaining historical period to be examined, that of the past four decades, represents a fundamental shift in the fault lines of fiscal policymaking. For a number of reasons, the last forty

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<sup>43</sup> Gordon (2010), p. 207

<sup>44</sup> Barlett and Steele (1994), p. 99

<sup>45</sup> Barlett and Steele (1994), p. 99-101

<sup>46</sup> Barlett and Steele (1994), p. 101

<sup>47</sup> Gordon (2010), p. 207-208

years have been remarkably distinct by historical-economic standards, and a sufficient examination of the causes of this changing time will play no small part in our ability to understand the political economy of the U.S. in 2011 and beyond.

### **The 1970s: Inflation and Folly**

The 1970s seem to represent a prime example of misguided economic policy during a time of difficult policy choices. By the start of this decade, much of the policymaking difficulty revolved around the perceived tradeoff between high inflation and high unemployment levels. The inflationary conditions arose first, as average yearly inflation had increased from 1.59 percent in 1965 to 5.84 percent in 1970.<sup>48</sup> According to Robert Samuelson, “High inflation had weakened U.S. exports, and a deteriorating trade balance threatened huge gold withdrawals by foreign governments.”<sup>49</sup> One reason why this development was such a concern was that the U.S. was still on the gold exchange standard, whereby foreign governments could exchange money for gold at \$35 an ounce. Therefore, when nations began converting dollars into gold – as Britain and France did in 1971 to the combined tune of \$800 million- U.S. gold stocks plummeted.<sup>50</sup> This in turn forced the U.S. government to greatly increase the amount of printed dollars in 1971 in order to maintain payment for efforts in the Viet Nam War and other expenses. Furthermore, as unemployment jumped from 3.9 to 6.1 percent merely from the beginning of 1970 to the last month of the year, and hovered around 6 percent for all of 1971<sup>51</sup>, President Richard Nixon set out to address the inflation problem, without exacerbating unemployment, in one sweeping action on August 15, 1971. His two-pronged solution was to announce that the

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<sup>48</sup> Inflationdata.com, 2/19/11

<sup>49</sup> Samuelson (2008), p. 98

<sup>50</sup> Samuelson (2008), p. 98

<sup>51</sup> Wall Street Journal (4/1/11)

U.S. would no longer pay gold at the \$35 per ounce rate to foreign governments, thereby allowing the price of gold and thus the value of the dollar to float according to supply and demand, and to establish a ninety-day freeze on prices and wages across the entire economy. Where the unprecedented emergence of a U.S. trade deficit- compounded by the second-highest post-WWII federal budget deficit, at \$23 billion<sup>52</sup>- perhaps forced Nixon's hand in closing the gold window, the across-the-board wage and price controls were another matter altogether. In 1970 the Congress had authorized Nixon to enforce wage and price controls, which he did the next year, and the initial ninety-day freeze eventually turned into over two years of controls with varying degrees and exemptions by product and sector, and "voluntary restraints" into 1974. As Bartlett explains, a total inadequacy to combat inflation could have been expected: "It is in the nature of price controls that they break down after a short time. One reason is that basic commodities like oil and agricultural output can't really be controlled. And eventually the bureaucracy controlling prices simply ceases to be effective. By 1974 Nixon's price controls were breaking down rapidly, allowing pent-up inflation to explode."<sup>53</sup> Additionally, federal spending increased greatly under Nixon's watch, as outlays grew from \$178.9 billion in 1968 to \$269.3 billion in 1974.<sup>54</sup> One reason was the expansion of the regulatory agencies at this time, including the creation of the Environmental Protection Agency and the Occupational Safety and Health Administration (OSHA).

Though the deep recession of 1974-1975 was certainly connected to the Arab oil embargo, which lasted from October 1973 to March 1974, it is a common mistake to chalk up all the inflationary pressure of the 1970s to this external shock to the economy and the oil crisis of 1979. Economic

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<sup>52</sup> Gordon (2010), p. 206-207

<sup>53</sup> Bartlett (2009), p. 87

<sup>54</sup> Gordon (2010), p. 207

studies suggest that there were other factors pushing up inflation.<sup>55</sup> An equally important point to consider is the damaging effect of government policy at this time. In the 10 months *before* the oil embargo, December 1972 to October 1973, the inflation rate more than doubled from 3.41 percent to 7.8 percent.<sup>56</sup> This development strongly suggests the futility of Nixon's wage and price controls, which exacerbated the inflation they were designed to prevent.

From the time of Nixon's inauguration in January of 1969 to the end of his last year as President in 1974 (in which he resigned in August), the unemployment rate jumped from 3.4 to 7.2 percent<sup>57</sup>, and the inflation rate nearly tripled from 3.4 to 12.34 percent.<sup>58</sup> Furthermore, even though wage and price controls were lifted by 1974, price controls on oil and natural gas were enforced throughout the rest of the decade. The evidence from this time period indicates both the logistical complexities of such regulation echoed by Bartlett, and the sheer faulty economics which gave rise to their utilization. Some 32 separate prices for natural gas and multi-tiered oil prices were established<sup>59</sup>, none of which could overcome the fact that when prices on domestic production were arbitrarily suppressed, energy consumption exceeded what it would have been otherwise.<sup>60</sup> Consequently, the supply for this artificially-bolstered demand had to come from foreign energy sources<sup>61</sup>, effectively providing a subsidy for the OPEC suppliers whose unilateral controls were (and still are) presented as the sole causation of the crisis.

Controls on energy prices were perpetuated throughout the rest of the 1970s in the administrations of Presidents Gerald Ford and Jimmy Carter. The failure to contain inflation throughout the decade coincided with failed policies to reduce unemployment. Part of the

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<sup>55</sup> DeLong (12/19/95), Barsky and Kilian (Feb. 2000)

<sup>56</sup> Inflationdata.com, 2/19/11

<sup>57</sup> Wall Street Journal (4/1/11)

<sup>58</sup> Inflationdata.com, 2/19/11

<sup>59</sup> Pbs.org, 2/25/11

<sup>60</sup> Laffer et al. (2008), p. 78

<sup>61</sup> Pbs.org, 2/15/11, Laffer et al. (2008), p. 78

problem was that the very structure of our government does not provide well for quick legislative action to address immediate economic issues; the intricate arrangement of checks and balances combined with all three branches of government being separate and co-equal, makes it difficult for the legislative process to respond to immediate, short-term economic threats. One case in point was the rebate program designed to mitigate the recession of 1974-1975, a \$22.8 billion package including extended unemployment benefits (\$184 billion today) which might have been successful had it been implemented before March of 1975, the last month of the recession.<sup>62</sup>

There were also economic and logistical impediments to the governments' well-intentioned attempts to stimulate growth. The Antirecession Fiscal Assistance Program and the Local Public Works Program, both of 1976, were designed to stimulate a struggling economy through construction and infrastructure projects. The AFAP, which Congress passed over President Ford's veto, and the LPWP both struggled as they could not be implemented fast enough. With most of the funding going to state and local governments, they tended to save the money and build surpluses, which negated any stimulative potential.<sup>63</sup> According to Bartlett, "Only 12 percent of workers on LPW projects were previously unemployed", and the "average job lasted just 2.6 months."<sup>64</sup> In fact, these same obstacles menaced similar efforts early in President Ronald Reagan's administration. Even with the \$33.5 billion (\$136 billion today) Surface and Transportation Assistance Act and \$9 billion (\$37 billion today) Emergency Jobs Act being passed in the recession year of 1982, "Employment in highway construction increased less than total employment in the year following passage of the legislation."<sup>65</sup>

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<sup>62</sup> Bartlett (2009), p. 87

<sup>63</sup> Bartlett (2009), p. 88

<sup>64</sup> Bartlett (2009), p. 88

<sup>65</sup> Bartlett (2009), p. 90

The end result of this great confluence of monetary changes, oil shocks, and fiscal policy in the 1970s, was a condition long thought impossible by many political-economic pundits: stagflation, or a state of both high inflation and high unemployment. By 1980, unemployment was at 7.2 percent<sup>66</sup>, a floor which unfortunately would not be lowered until 1984, and inflation had risen to a staggering 13.6 percent.<sup>67</sup> Thus, a decade of policies which had been designed to contain a bursting of pent-up inflationary pressure, without allowing for increased unemployment, ended up accomplishing neither objective. In the end, this development was what broke the consensus on Keynesian economics. Deficit spending (not a single balanced budget was achieved in the decade) including significant investment in both public works and the military, and an expansive monetary policy<sup>68</sup>, ultimately could not prevent either economic stagnation or inflation.

At first glance, the low federal debt in the 1970s (which remained steadfast in the range of 35 percent of GDP<sup>69</sup>) stands out in comparison with the debt levels from every other post-depression era. However, this was not due to uncommonly prudent fiscal policy. In fact, the average federal budget deficit from 1970 to 1979 was 2 percent of GDP, following a deficit average from 1960 to 1969 which registered at just .72 percent of GDP.<sup>70</sup> It is only relative to the historically large deficit levels of the subsequent era that the 1970s deficits look small. But even this point greatly understates the economic and fiscal decline of the 1970s. The two primary reasons why the federal debt clung to a post-depression low in this period were the economic boom and fiscal performance of the 1960s, and the fact that the historically high inflation of the 1970s pushed millions of taxpayers into higher nominal tax brackets (the infamous bracket

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<sup>66</sup> Wall Street Journal (4/1/11)

<sup>67</sup> Inflationdata.com, 2/19/11

<sup>68</sup> Barsky and Kilian (2000), p. 33

<sup>69</sup> Gordon (2010), p. 207

<sup>70</sup> Chantrill, 2/29/11

creep) than those same taxpayers would have been in absent such high inflation.<sup>71</sup> Gordon provides a succinct explanation of why the low nominal debt-to-GDP ratio of this era was highly misleading: “Inflation causes assets with a fixed dollar value, such as federal bonds, to shrink in value relative to other commodities that can rise in price. This, in turn, causes the federal debt to shrink relative to the GDP, impoverishing the bond holders in the process.”<sup>72</sup>

### **The 1980s: Reaganomics**

There is a wealth of literature on the political-economic conditions of the 1980s, and the precedents set in that decade for all national fiscal policy in the subsequent time period. To offer the entire story of the conservative movements’ ascendance to the Presidency and policy clout in this time would take another thesis altogether. However, we can embark upon a general examination of the fiscal record of this mercurial decade. In doing so, it becomes apparent that the legacy of Reaganomics is more complicated than either supporters or opponents let on, and has contributed mightily to the ideological divide threatening our ability to address the challenges of the emerging fiscal crisis.

However, we cannot examine the history of Reaganomics without understanding the eventual and painful resolution of the problem we left off with, the runaway inflation of the 1970s. With inflation averaging 11.22 percent in 1979 and 13.58 percent in 1980, both historically high levels for the U.S., the need to combat this rise was a top priority for Ronald Reagan from his first day as President. Reagan retained President Carter’s Federal Reserve chair, Democrat Paul Volcker, who had initiated efforts to restrict the money supply by letting interest rates rise in 1979 and

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<sup>71</sup> Ehrman (2005), p. 31

<sup>72</sup> Gordon (2010), p. 151

1980.<sup>73</sup> However, unemployment continued to rise in this time while inflation had grown to a dangerous level. Thus, by Reagan's inauguration in 1981 the stagflation problem was so pressing, and its monetary root so central to both Volcker and Reagan's understanding of it, that only the most aggressively restrictive monetary shocks would suffice in the hopes of curbing the inflation; and if this result were to occur, it would only come at major short-term economic pain in the form of unemployment.

Yet, Reagan defied this risk and remained steadfast in his support of a restrictive Fed monetary policy.<sup>74</sup> This political cover for the Fed's activities aided the collective patience necessary for such an uncommonly austere set of policies to succeed, as Congressional criticism of the Fed was hardly a novel subject- and greatly intensified by the enormity of this instance.<sup>75</sup> Undeterred, Volcker led the Federal Reserve in continuation of the restrictive monetary policies begun in the latter part of President Carter's tenure. The federal funds rate- the interest rate for loans between private banks using Fed funds- rose from 7 to 11 percent between the summer of 1978 and that of 1979, and to an extreme level of 20 percent in 1981, which resulted in an increase in the prime lending rate- the rate which commercial banks charge their most creditworthy customers- to 21 percent in 1981.<sup>76</sup> The federal funds rate would not fall below 10 percent until late 1982. These extraordinarily high interest rates, and the resulting restriction of the money supply, effectively put the brakes on the economy- which the deep and painful recession of 1981-1982 made clear. Unemployment reached 8.3 percent in November 1981 and did not drop below this rate until January of 1984<sup>77</sup>, often lingering in the 10 percent range throughout this time, easily a post-depression high until it was matched by the great recession. Testimonies to the economic

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<sup>73</sup> Ehrman (2005), p. 40

<sup>74</sup> Samuelson (2008), p. 110

<sup>75</sup> Samuelson (2008), p. 113

<sup>76</sup> [Newyorkfed.org](http://Newyorkfed.org) (12/22/08)

<sup>77</sup> Wall Street Journal (4/1/11)

pain suffered by many Americans in this time period are vivid: “The number of business failures in 1982 (24,908) was nearly 50 percent higher than any other year since World War II, and it would double to 52,078 by 1984. From 1979 to 1983, farm income declined almost 50 percent.”<sup>78</sup> However, the overriding goal of curbing inflation was achieved in remarkable fashion, as the average inflation rate decreased from 13.58 percent in 1980 to just 3.22 percent in 1983.<sup>79</sup> Without this tremendous reversal, it is hard to argue that the stagflation, bracket creep, and weakening dollar of the late 1970s wouldn’t have continued to erode the state of the economy, with consequences we thankfully will never know.

Meanwhile, the fiscal policies which came to be known as “Reaganomics” began in earnest at the start of Reagan’s first term in 1981. This initial year saw the enactment of the Economic Recovery and Tax Act (ERTA). This law phased in overall tax cuts of 25 percent over three years, reducing the top marginal income tax rate from 70 to 50 percent and the capital gains rate from 28 to 20 percent, and included numerous additional provisions. The immediate budgetary result, no doubt affected by the struggling economy, was to produce the largest peace time federal deficit in U.S. history, which reached nearly 6 percent of GDP in 1983<sup>80</sup>. Even through the end of 1985, when the economy had recovered and was beginning to thrive again, the yearly deficit still registered at 5.04 percent of GDP.<sup>81</sup>

Thus, the administration had no choice but to work with Congress for the purpose of major deficit reduction. The first such example was the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which rather than altering income tax rates, instead tightened tax rules and closed loopholes in an attempt to garner more revenue. This legislation included an increase in

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<sup>78</sup> Samuelson (2008), p. 135

<sup>79</sup> Inflationdata.com, 2/19/11

<sup>80</sup> Chantrill, 3/19/11, Gordon (2010), p. 207-209

<sup>81</sup> Chantrill, 3/19/11

the FUTA tax rate on wage employment which pays for unemployment insurance and benefits, and a temporary increase in excise taxes. While the unemployment and excise taxes were quite regressive methods to raise greater revenues, the overall impact of TEFRA was “the largest peacetime tax increase in American history”, which raised taxes to the tune of \$57.3 billion.<sup>82</sup> Furthermore, 1983’s Social Security Amendments raised the payroll tax gradually to its current combined total 15.3 percent rate by 1990<sup>83</sup>; yet, as FICA is the most regressive federal levy, meaning lower-income individuals and businesses pay a far higher percentage of their income in compliance with it, this permanently increased tax burden fell squarely on the shoulders of lower-income workers and small business owners.

One tax triumph of the 1980s was the Tax Reform Act (TRA) of 1986, which closed and limited a plethora of expensive loopholes and tax expenditures, representing a truly outstanding bipartisan effort to alleviate a fiscal problem that was well entrenched (and, unfortunately, would become so again). According to one study, “Overall, the bill closed an estimated \$500 billion in loopholes over five years, and used those revenues to reduce tax rates.”<sup>84</sup> With such a comprehensive reform of the tax code greatly widening the revenue base, this enabled the reduction of the top marginal income tax rate from 50 to 28 percent.

Ultimately, according to the Office of Management and Budget (OMB) there were an estimated \$275.3 billion in cumulative tax cuts in the Reagan years, of which \$264.4 billion were contributed by ERTA in 1981.<sup>85</sup> Yet, as we have seen, after the ERTA tax rate reductions the rest of the Reagan tax policy mostly centered on tax increases, with cumulative increases registering

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<sup>82</sup> Bartlett (2009), p. 153

<sup>83</sup> Ssa.gov, (11/26/84)

<sup>84</sup> Ctj.org, 4/15/11

<sup>85</sup> Bartlett (2009), p. 153

at \$132.7 billion<sup>86</sup>. The fact that such a strong advocate for limited government felt it necessary to increase taxes, and was willing to risk the fallout from raising the Social Security levies on workers and businesses, signals how serious the need for deficit reduction was after 1981.

However, Congress and President Reagan should certainly be given credit for what turned out to be arguably the greatest consistent effort to shore up the complexities and inequities hidden in the tax code. In addition to TEFRA in 1982 and the TRA of 1986, the Deficit Reduction Act of 1984 included similar reforms and added \$25.4 billion in increased revenue.<sup>87</sup>

Despite this flurry of tax reform, first to stimulate economic growth and then secondly to shore up the budget, federal deficits remained historically high throughout the entire decade. From 1982 to 1989, the lowest yearly deficit total was the \$127.99 billion of 1982, a figure which at first set a high deficit record, but which would unfortunately be surpassed by every subsequent year of the decade.<sup>88</sup> The years of 1983, 1985, and 1986 each checked in with deficits well in excess of \$200 billion. This obviously increased the national debt, which rose from 34.5 percent of GDP in 1980 to 58.15 percent of GDP in 1990.<sup>89</sup>

There are three primary reasons why federal deficits were so large throughout all of the 1980s. First, after a decade of record cuts in overall income tax rates, which included a drop in the top marginal income rate from 70 percent at the beginning of the decade to just 28 percent at its end, only the most extreme supply-side philosophy could have reached an expectation of the resulting revenues to cover all of the modern government's expenses. There is no doubt that the tax rate reductions provided a boost to the economy during a time of stagnation, just as the two great tax cut epochs of the 1920s and 1960s had done before. However, the size and scope of federal

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<sup>86</sup> Bartlett (2009), p. 153

<sup>87</sup> Bartlett (2009), p. 153

<sup>88</sup> Gordon (2010), p. 207-208

<sup>89</sup> Gordon (2010), p. 207-208

spending was much more expansive by Reagan's presidency than in these previous eras, and the progressive income tax structure no longer relied single-handedly on the highest-income taxpayers as it had in the 1920s.

The aforementioned extreme shift in the degree to which higher-income taxpayers reduced the sheltering of earnings and tax avoidance in the 1920s, a key factor in the surprising revenue totals of that decade, suggests that the previous World War I taxes were kept at punitive levels. The tax revenue production of the Reagan years, at 18 percent of GDP<sup>90</sup>, modestly mirrored the revenue average of the entire post-World War II era, even with all the assistance of the deficit reduction measures after 1981. By the time of Reagan's presidency, with the majority of citizens paying income taxes, the stimulation of economic activity (and by extension, of tax revenues) to be gained by focusing tax cuts on those at the very top of the income ladder was easily a smaller share of the nation's total productive capacity than it had been in the 1920s.

Additionally, the lower tax rates became throughout the 1980s, the less significant stimulation of economic growth could be expected from any individual tax cut. This is a point which has certainly been overlooked by the most ardent supply-side advocates in the post-1980 fiscal debate. Reagan and the Congresses of the 1980s were right, initially, to relieve American taxpayers and businesses of the high income tax rates in place at the start of the administration; however, just as with every other type of policy, tax-cutting has its limits, which the deficits of the 1980s- and later, the 2000s- made perfectly clear.

The second explanation for the large deficits of the 1980s was the effect of disinflation. As Bartlett puts it, "Since taxes are assessed on nominal incomes, not real incomes, the fall of inflation from 12 percent in 1980 to about 4 percent in 1982 and throughout the 1980s simply

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<sup>90</sup> Bartlett (2009), p. 119

collapsed the expected tax base.”<sup>91</sup> Further evidence of this development is provided by the Carter administration’s last budget, which forecasted for inflation to be 9.6 percent in 1982<sup>92</sup>; instead, with the inflation rate radically curtailed to 3.8 percent by the last month of that year, a correlating tax revenue depletion of as much as \$64 billion could have been expected, a total amounting to half of the 1982 federal deficit.<sup>93</sup> As the decade began with the unprecedented level of 13.58 percent inflation, by 1986 the yearly inflation rate had dropped all the way to 1.91 percent. Thus, it seems fair to conclude that the record-high budget deficits of the Reagan years cannot be understood without taking into consideration the extraordinary disinflation of the era, and the tremendous impact it had on nominal income.

The third and final explanation for the budgetary struggles of the 1980s was the increased defense spending. This spending was of course part of Reagan’s overall national security strategy in the twilight of the Cold War with the U.S.S.R., yet, this is a wholly inappropriate forum in which to hypothesize on that late Cold War struggle. For our purposes, the defense spending of the Reagan years is most important in relation to the budget at that time and the fiscal policy agenda of the administration.

Defense spending in the 1980s was less robust than is often assumed. Whereas defense spending usually hovered in the range of 10 to 11 percent of GDP from 1950 to 1970 (and higher in the Korean War years), the range was 6 to 7 percent of GDP in the 1980s.<sup>94</sup> However, defense still constituted a comparatively large portion of the budget in this era, and such spending was a significantly higher percentage of GDP than in the 1990s. The primary reason why this spending exerted fiscal stress was because the budget was already strained by the large tax reductions and

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<sup>91</sup> Bartlett (2009), p. 121

<sup>92</sup> Bartlett (2009), p. 121

<sup>93</sup> Bartlett (2009), p. 121, Inflationdata.com, 2/19/11

<sup>94</sup> Chantrill, 3/19/11

the effects of disinflation. The combination of these three factors made it impossible for the government to maintain control of the deficit. Additionally, despite Reagan's passionate campaign for reducing the size of government, total federal spending stayed roughly constant through the Reagan years in the range of 21 percent of GDP.<sup>95</sup> The administration noted often that this was the result of a Congress unwilling to work with the President on domestic discretionary spending reductions (even though these expenditures still declined), but given the increases in the defense budget, overall reductions in spending were an unrealistic expectation. In sum, Reaganomics presented us with a mixed record. The defeat of inflation was the primary achievement, as Samuelson emphasizes in his apt summary of the Reagan fiscal record: "Of all Reagan's achievements, this [inflation] was the most definitive. Indeed, the rest of his economic record was mixed. Although he reduced tax rates and simplified the tax code, federal government spending as a share of national income barely changed during his two terms; tax burdens did drop, and budget deficits rose."<sup>96</sup> The supply-side underpinnings of Reaganomics certainly went too far in positing that balanced budgets were possible in the midst of record tax cuts and increased defense spending, a fact which is strongly suggested by the need for years of tax-increasing legislation. However, this philosophy of government still managed to carve out the essential fault lines of fiscal politics which have remained ever since.

### **The 1990s: Deficit Reduction and the Tech Boom**

President George H. Bush is often criticized for signing the Omnibus Budget Reconciliation Act of 1990, and many ascribed his defeat in the 1992 election to Bill Clinton to this one decision. However, the large budget deficits of the 1980s and the need to pay for U.S.

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<sup>95</sup> Chantrill, 3/19/11, Samuelson (2008), p. 136

<sup>96</sup> Samuelson (2008), p. 135

efforts in the Gulf War prompted this decision, which saw the top income tax rate increase from 28 to 31 percent (not including capital gains), an increased wage cap for the Medicare portion of FICA, and an expanded earned income tax credit (EITC) for employed low-income families.<sup>97</sup> It has been estimated that the bill reduced the average tax burden for the 40 percent lowest-income families.<sup>98</sup> The timing of this new tax law (from a macroeconomic standpoint) was far from preferable, as the first years of its rates and rule changes came in a time of recession. As a result of this and the need to fund the Gulf War, yearly deficits remained high and the national debt increased from 58.15 percent of GDP in 1990 to 68.91 percent in 1994.<sup>99</sup>

Thus, President Bill Clinton assumed office in a time where the economy was undoubtedly the number one issue on voter's minds. With the Soviet Union dissolved, and the Gulf War brought to a swift conclusion, by Clinton's inauguration in January 1993 it was time to focus on domestic issues. Many recall the Hillary Clinton-led health reform effort which stalled in Congress in this first year of the new administration, but 1993 also saw the enactment of significant changes in the tax structure. The Omnibus Budget Reconciliation Act of 1993 created two new top income tax brackets at levels of 36 and 39.6 percent, eliminated the wage cap on the Medicare portion of FICA, raised taxes on high-income Social Security benefits, and further expanded the earned income tax credit.<sup>100</sup>

Opinions vary on just how much this legislation was responsible for the deficit reduction, reduced debt, and eventual balanced budget which would mark the fiscal record of the decade. Citizens for Tax Justice has stated that the "1993 deficit reduction bill was arguably the single biggest legislative contribution to the budget surpluses that have been achieved in the late

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<sup>97</sup> Ctj.org, 4/15/11

<sup>98</sup> Ctj.org, 4/15/11

<sup>99</sup> Gordon (2010), p. 208

<sup>100</sup> Ctj.org, 4/15/11

1990s.”<sup>101</sup> Others ascribe these fiscal achievements to the Republican-led Congress, fueled as they were by conservative House Speaker Newt Gingrich and the “Contract with America” after their 1994 mid-term electoral triumph. And it is undeniable that the surging late-1990s economy emanating from the high-tech boom played a large role in generating greater tax revenues than would have otherwise been expected, thereby greatly aiding the deficit reduction.<sup>102</sup>

However, the role of Clinton’s fiscal policy agenda throughout his two terms is easily the most understated reason for the budgetary success of the 1990s. For one, the federal deficit decreased markedly in the last four fiscal years before the policies of the Gingrich-led Republicans would begin to take effect, as it dropped from 4.58 percent of GDP in 1992 to just 2.21 percent in 1995.<sup>103</sup> This certainly suggests the significant deficit-reducing impacts of the 1993 tax changes, and also reflects post-Cold War reductions in defense spending, which decreased by 22 percent between 1991 and 1995.<sup>104</sup> As a whole, federal spending decreased by nearly 1.5 percent of GDP in these years, from 21.78 percent in 1992 to 20.44 percent by 1995.<sup>105</sup> This was the result of a reduction in discretionary spending- including defense- from 9.1 percent of GDP in 1991 to roughly 7.5 percent of GDP in 1995, as Figure 1 shows below.

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<sup>101</sup> Ctj.org, 4/15/11

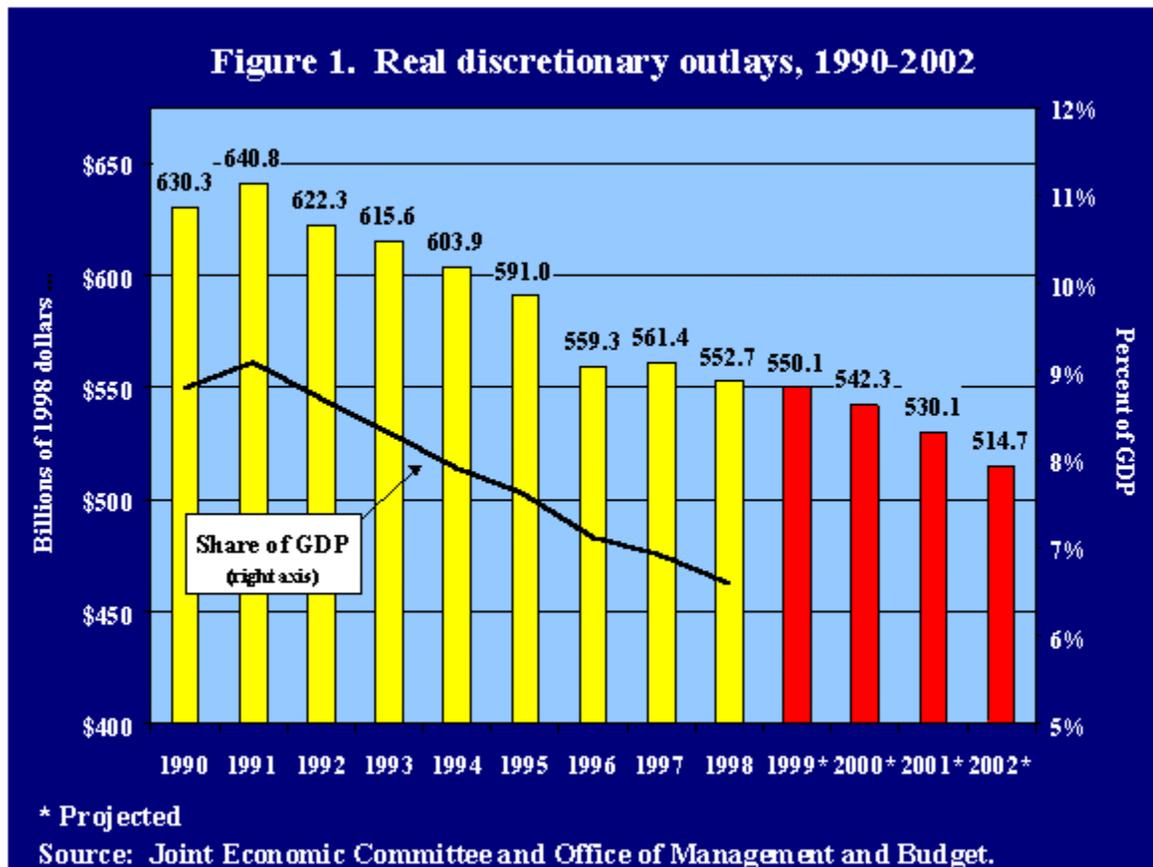
<sup>102</sup> Gordon (2010), p. 164

<sup>103</sup> Chantrill, 3/19/11

<sup>104</sup> House.gov (April 1999)

<sup>105</sup> Chantrill, 3/19/11

Figure 1- Federal Discretionary Spending Reductions from 1990 through 2002



Source: [www.house.gov/jec/fiscal/budget/restrain/fig-1.gif](http://www.house.gov/jec/fiscal/budget/restrain/fig-1.gif)

Secondly, Clinton's own moderate philosophy of governance and commitment to fiscal responsibility should not be underestimated. The Personal Responsibility and Work Opportunity Act of 1996, which created the Temporary Assistance for Needy Families (or TANF) program, was the culmination of a welfare reform effort which Clinton had passionately touted for years before the bill traveled through the legislative process. The core distinction between this program and its predecessor, Aid to Families with Dependent Children (AFDC), is that TANF provides temporary financial assistance to qualifying families in return for efforts to attain employment. Although there were many tough negotiations and some painful compromises with the House

Republicans on the specifics of the bill<sup>106</sup>, Clinton stuck to his centrist position on the issue and ended up signing into law a program which helped many people to get back into the workforce.<sup>107</sup> Clinton's support of the North American Free Trade Agreement (NAFTA) provided further evidence of his centrist and generally free-market economic approach. Lastly, Clinton's more fiscally prudent instincts manifested in efficiency improvements in both the defense budget and the overall federal workforce. In his tenure, defense spending decreased from 5.16 percent of GDP in 1993 to 3.56 percent in 2001.<sup>108</sup> Clinton was criticized by Republicans for presiding over this peacetime era of gradually decreasing Pentagon budgets, yet, this period still witnessed major investments in new weaponry and technology as well as boosts in compensation for military personnel and benefits for such retirees<sup>109</sup>, efforts which greatly assisted the military challenges that were soon to come in the following decade. Furthermore, Clinton's efforts to modernize the government bureaucracy would have been a major accomplishment in any administration. According to Klein, "The federal workforce would be reduced by about 350,000 and an estimated \$157 billion saved. Equally important, 16,000 pages of bureaucratic regulations would be tossed."<sup>110</sup> Overall, the discretionary budget (expenditures authorized in annual appropriation bills, rather than mandatory spending such as Medicare and Social Security) decreased from 9.1 percent of GDP in 1991 to 6.6 percent of GDP by 1999.<sup>111</sup>

The end result of all the fiscal, economic, and monetary reforms from the early 1980s through the late 1990s (the disinflation and reduced marginal income tax burdens of the Reagan years,

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<sup>106</sup> Klein (2002), p. 151

<sup>107</sup> Acf.hhs.gov (2/16/11)

<sup>108</sup> Chantrill, 3/19/11

<sup>109</sup> Nider (6/30/03)

<sup>110</sup> Klein (2002), p. 67

<sup>111</sup> House.gov ( Apr. 1999)

and the deficit/debt reduction, bureaucratic modernization, and free trade reforms of the 1990s) was a great contribution to the burgeoning high-tech industry, which then pushed the American economy through the roof in Clinton's second term. The Clinton years witnessed a 3.6 percent average economic growth rate while stock prices shot up by an 11.2 percent yearly rate<sup>112</sup>, and included the creation of 23 million jobs. This, in turn, produced the surprise budget surpluses of the last four fiscal years of Clinton's presidency: \$69.2 billion in 1998, \$125.6 billion in 1999, \$236.2 billion in 2000, and \$128.2 billion in 2001.<sup>113</sup> The federal budget had not been in surplus since 1969. Consequently, the national debt decreased from 68.91 percent of GDP in 1994 to 57.0 percent by 2001.<sup>114</sup>

### **The 2000s: The Abandonment of Fiscal Discipline and the Emerging Fiscal Crisis**

Upon his triumph in the controversial 2000 presidential election, President George W. Bush embarked on a tenure which Republicans saw as an opportunity to continue and even extend the legacy of Reaganomics. The Republicans controlled the House of Representatives for all but the final two years of Bush's presidency, and controlled the Senate after the 2002 mid-term elections through 2006. The "starve the beast" budgetary approach was now given its widest opening in the policymaking process, and the evidence suggests that it was a driving force in the objectives of the new Republican leadership in Washington.<sup>115</sup>

However, after the 1980s had proven the limits of this fiscal and economic philosophy, the 2000s would illuminate the damaging effects of carrying such an ideological straitjacket into an era where federal income tax burdens were far more reasonable than they had been in the 1980s, while the forces ensuring large government spending- from all sides of the political spectrum-

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<sup>112</sup> Mandel (6/21/04)

<sup>113</sup> Gordon (2010), p. 208

<sup>114</sup> Gordon (2010), p. 208

<sup>115</sup> Bartlett (2009), p. 159-161

were entirely unabated. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 reduced income tax rates at all bracket levels, including dropping the top marginal rate from 39.6 to 35 percent, yet added many new deductions and exemptions to the tax code.<sup>116</sup>

These provisions were due to sunset by the start of 2011, but were extended in late 2010.

Additionally, one-time tax rebate checks were mailed to all citizens who filed tax returns in 2000, a process which did little to stunt the burgeoning recession as these payments were mostly saved rather than being pumped into the economy when the stimulus was needed.<sup>117</sup> The overall price tag of these tax cuts has been estimated at \$1.3 trillion dollars<sup>118</sup> (pre-2010 extension).

The national tragedy of September 11, 2001 obviously contributed to the recession of 2001 and economic downturn which persisted into 2003. However, the 2001 tax law did little to stimulate the economy, as payroll employment dropped from 112 million in 2001 to 108 million by 2003, even though the recession technically ended in late 2001.<sup>119</sup>

Federal spending significantly increased in this time, from 17.98 percent of GDP in 2000 to 19.39 percent by 2003, a time in which the federal budget went from a surplus of 2.37 percent of GDP to a deficit of 3.39 percent.<sup>120</sup> As a result, Congress and the administration set out to pass the Jobs and Growth Tax Relief Act of 2003 (JGTRRA), which expedited the phase-in schedules of provisions from the 2001 law and reduced the top tax rates on capital gains and dividends to 15 percent.<sup>121</sup> This legislation ended up with a budgetary cost of \$350 billion for the next decade.

The combination of these tax cuts with significant increases in entitlement and defense spending created an unsustainable budgetary balance. Defense spending increased from 3.56 to 5.63

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<sup>116</sup> Slemrod and Bakija (2004), p. 26

<sup>117</sup> Laffer et al. (2008), p. 139

<sup>118</sup> Slemrod and Bakija (2004), p. 27, Wroe and Herbert (2009), 'President Bush and the Economy' by Graham Wilson, p. 151

<sup>119</sup> Laffer et al. (2008), p. 139

<sup>120</sup> Chantrill, 3/19/11

<sup>121</sup> Slemrod and Bakija (2004), p. 127

percent of GDP in the Bush years<sup>122</sup>, an amount which doesn't even include much of the funding for the Afghanistan and Iraq wars, which came courtesy of supplemental appropriations not counted in the official yearly Pentagon budgets. Additionally, the administration's response to the tragic events of September 11, 2001 included the creation of the Department of Homeland Security and extension of other national security-related expenses through a number of government agencies. According to one study, by 2009 this spending expansion had increased the total of all defense-related expenditures to over \$1 trillion annually, with the Pentagon budget itself accounting for less than two-thirds of the total amount.<sup>123</sup>

The Bush administration was also responsible for the 2003 enactment of the Medicare Prescription Drug, Improvement, and Modernization Act, creating Medicare Part D- a prescription drug subsidy program which is slated to cost at least \$550 billion between 2006 and 2015<sup>124</sup> and which will become increasingly costly thereafter as the baby boom generation retires. Overall, both total federal spending and nondefense spending increased far more in the Bush years than that of any other president since the 1970s, as shown in Figure 2 below.

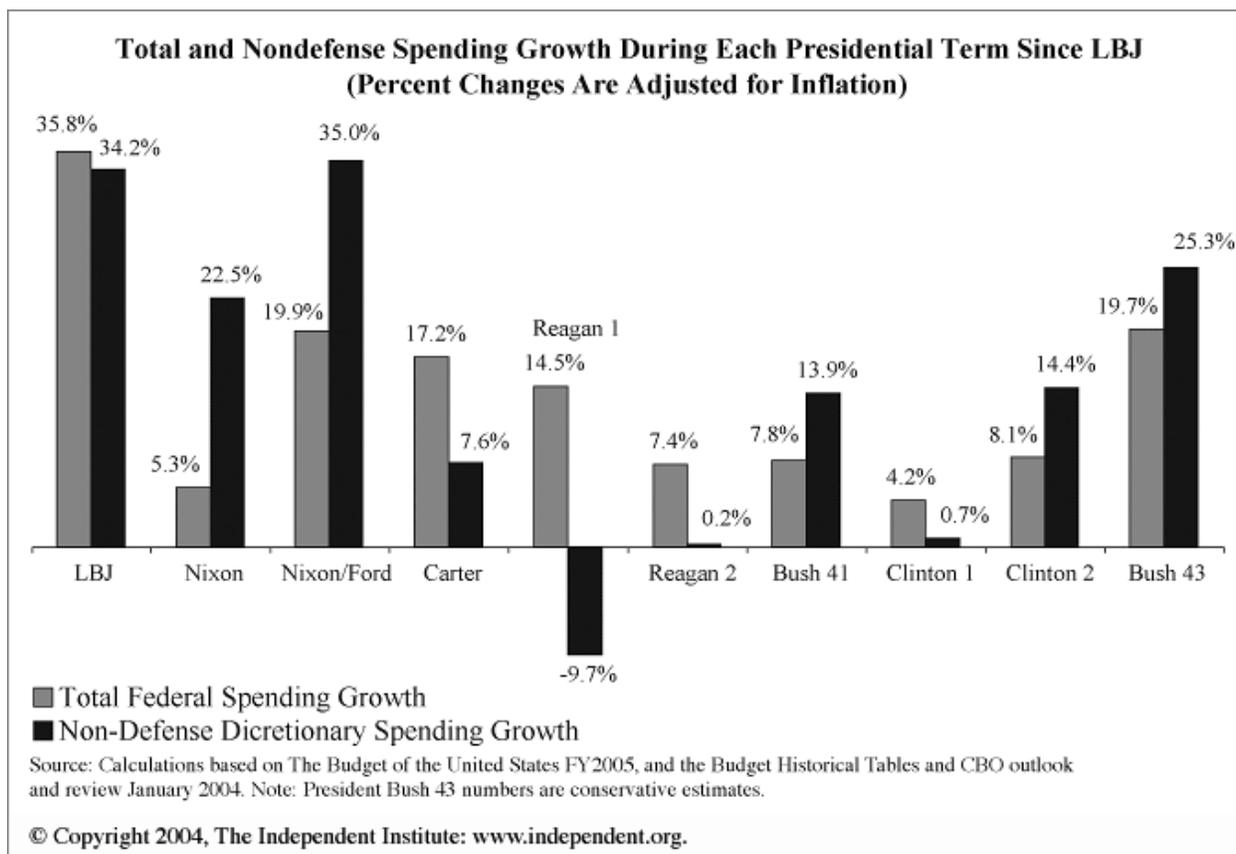
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<sup>122</sup> Chantrill, 3/19/11

<sup>123</sup> Higgs (4/17/10)

<sup>124</sup> Cms.hhs.gov (2009), p. 120

**Figure 2- Federal Spending Growth by Presidential Term since Lyndon Johnson**



Source: [http://www.independent.org/newsroom/news\\_detail.asp?newsID=31](http://www.independent.org/newsroom/news_detail.asp?newsID=31)

The end result of all of these expenditures and unwillingness to raise revenues adequate for their funding, was an exacerbation of budgetary stress even in the midst of the economic growth of 2003 to 2007, which we now know to have been driven by inflated housing prices. Between fiscal years 2003 and 2008, the federal deficit was greater than \$248 billion in all years but one, and nearly \$3 trillion were added to the national debt<sup>125</sup>, a figure which includes supplemental war funding that had been masked by its absence from annual budget bills.

<sup>125</sup> Gordon (2010), p. 208

When the housing crisis hit, imperiling all of the mortgage-backed securities and culminating in the Wall Street crash of September 2008, the government was quick to step in with funding support in order to prevent calamity in the financial markets. This came in the form of the aforementioned TARP program. While the “too big to fail” precedent set by the originally-authorized \$700 billion of the bailout is highly concerning, the direct financial cost of TARP will not be high in budgetary terms. As a result of financial loans paid back to the Treasury and the other workings of the program, the CBO projected in late 2010 that the final TARP price tag to American taxpayers would not exceed \$25 billion, and could be much less.<sup>126</sup>

To the contrary, the underlying fiscal stress which has imperiled the nation’s collective resources in modern times continues to build in this prolonged stretch of economic difficulty. It is still early to wisely pass judgment on the performance of President Barack Obama and his administration in dealing with these immense fiscal challenges, as the funding and legal mechanisms of such action are still in play. The \$787 billion American Recovery and Reinvestment Act of 2009 (ARRA) was certainly necessary given the enormity of the challenge which provided for its creation. This economic stimulus package won’t create all the permanent employment opportunities that this country needs moving forward: but just as with TARP, the painful economic conditions would have been far worse without this temporary boost. On the topic of the recently-passed health reform, it is still far too early to tell whether or not this legislation will even overcome the attempts for its repeal, let alone what the long-term fiscal and economic impact will be of a program for which we have a limited detail of its operations. What we do know at this point is that the primary sources of our long-run fiscal dilemma are the social and health insurance costs now quickly rising and soon to skyrocket, and the failings of a tax system which is in desperate need of reform if we are to ever manage these rising

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<sup>126</sup> Gordon (12/17/10)

government costs. The country has now begun an era where *mandatory* government spending obligations are pushing the federal budget to levels that previous generations could not have dreamed of, while the tax system is so flawed that over 40 percent of the citizenry is completely outside of the income tax system, with most of this group possessing zero tax liability because of the utilization of tax breaks and loopholes.<sup>127</sup> Such a combination is obviously unsustainable, and it is to these topics that we now turn.

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<sup>127</sup> Hodge (3/30/06)

## **Chapter Five: The Fiscal Stress and Economic Indicators of an Emerging Crisis**

The most direct sign of the emerging fiscal crisis is represented by the immense challenges the U.S. government will face in attempting to fund social and health insurance amidst the retirement of the baby-boom generation. Thus, the first section of this chapter is devoted to illuminating the primary examples of this building fiscal stress, that of the entitlement expenditures through Social Security and Medicare. The second section then examines the increasing difficulties of generating tax revenues sufficient to pay for rising government expenditures, and the harmful and inequitable economic impact of the tax code's great complexity.

### **Social Security and Medicare**

The greatest spending obligations that this country will face from this point forward are those of Social Security insurance and Medicare. The very first point to stress is how fundamentally different these non-discretionary items are from the discretionary budget. When programs involving trillions of dollars in government exchange payments are in place, and in the case of Social Security and part of Medicare, are directly linked to one's lifetime tax contributions, the entrenchment of such payments is incalculable. As a fundamental principle, this legislated agreement between worker and government is inherently strong. Contrary to the other parts of the budget where the only role in funding decisions that the general public possesses is the right to vote for our representatives and advocate for desired outcomes, a citizen's life-long tax contribution for a specifically-defined benefit program, accruing

precedential weight through the passage of time, confers a certain democratic legitimacy that is not present to the same degree on other spending items.

This does not mean that citizens are contractually entitled to Social Security benefits, a concept which was denied by a 1960 Supreme Court ruling. As statutory law created by the Social Security Act of 1935, Social Security benefits granted at one point in time can be withdrawn later. However, there remains a stronger connection between the initial source and final destination of FICA funds than is the case with a plethora of other government expenditures and their general revenue sources. The country may decide to increase funding for the operation of a federal agency when only half of the electorate agrees to do so; these spending decisions are made with general revenues through the annual appropriations process, and can thus be modified in relatively short periods of time if the collective will desires it. Additionally, many of these programs do not necessarily impact each citizen to the same degree, or at all. To the contrary, a comparable alteration in Social Security- or some Medicare- payments cannot be arbitrarily disjoined from the original source of the funds: the labor of the citizens for whose benefit they were created.

Furthermore, as a practical matter, Social Security and Medicare have been successful by many important measures. In 2009, Social Security benefits accrued to the tune of \$452 billion for retired workers and their families, \$105 billion to survivors of deceased workers, and \$118 billion to disabled workers and their families.<sup>1</sup> Currently 44 million people collect Social Security benefits, as do seven million survivors of deceased workers, six million dependent spouses and children, and 4 million disabled workers. According to Census data, it is estimated that without these benefits 45 percent of all elderly citizens would be forced to live under the

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<sup>1</sup> Agresti and Cardone (1/27/11)

poverty line; instead 9.7 percent are impoverished.<sup>2</sup> Overall, Social Security lifts 19.8 million citizens over the poverty line, including 13.2 million seniors.

Medicare Part A, which covers hospital insurance for citizens of at least 65 years of age who are eligible for Social Security (or who are eligible by way of any of various other specific criteria), is funded by 1.45 percent of payroll tax contributions by both employees and employers, totaling 2.9 percent of such revenues.<sup>3</sup> Starting in 2013, this Hospital Insurance portion of the payroll tax is slated to increase from 2.9 to 3.8 percent on earned income above \$200,000 for individuals and \$250,000 for married couples filing jointly.<sup>4</sup> Thus, the same logic applies regarding the contributions that workers have made throughout their lives and the legislated and precedential weight of promised benefits upon retirement. Additionally, when workers retire, many will not have health insurance in an employer-based system (and we will see how the larger health reform plan develops in the coming years). As such, as long as the country includes millions of retirees who, through no fault of their own, were not able to build the savings for privately-funded health plans in older age, it only seems that what is appropriate and just for the strongest nation on earth is to reward their prior labor with basic health insurance.

System-wide benefits notwithstanding, there is no denying how serious of a fiscal challenge Social Security and Medicare are becoming for the U.S., and how much this challenge is sure to increase in the near future. Given the retirement of the baby boom generation (which is just now beginning, and will eventually entail the retirement of some 78 million citizens) and the social and health insurance payments that will be provided to them for many years, combined with the magnificent recent developments in health care technology and the high cost-increases pursuant to its utilization, the bottom line is clear: the costs of Social Security and Medicare will increase

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<sup>2</sup> Van de Water and Sherman (8/11/10)

<sup>3</sup> Ssa.gov (January 2011)

<sup>4</sup> Ssa.gov (3/2/11)

exponentially unless unlikely cuts in these programs are enacted. Under current law, projections indicate that by 2025 tax revenues will not be sufficient to cover *any* government expenditures beyond Medicare, Medicaid, Social Security, and interest payments on the national debt.<sup>5</sup>

A basic analysis of current revenues and entitlement expenditures shows how serious this fiscal challenge already is. Currently, the combined spending on Social Security, Medicare, and Medicaid amounts to 9.9 percent of GDP, and is expected to equal at least 12 percent of GDP by 2021.<sup>6</sup> To put this into context, in 2010 government revenues equaled 14.7 percent of GDP; this figure was only sufficient to cover roughly the entitlement programs and the Pentagon budget, meaning that the rest of the budget was in deficit.<sup>7</sup> Even in better economic conditions, 9.9 percent GDP spending on entitlements would represent more than half of the available annual revenues. This is evidenced by the fact that in the post-World War II era, tax revenues have averaged 18 percent of GDP<sup>8</sup>, and never exceeded the range of 20 percent of GDP—regardless of tax rates or composition.

According to this past year's fiscal commission initiated by President Obama, "When Franklin Roosevelt signed Social Security into law, average life expectancy was 64 and the earliest retirement age in Social Security was 65. Today, Americans on average live 14 years longer, retire three years earlier, and spend 20 years in retirement. In 1950, there were 16 workers per beneficiary; in 1960, there were 5 workers per beneficiary. Today, the ratio is 3:1- and by 2025 there will be just 2.3 workers "paying in" per beneficiary<sup>9</sup>." This difficult ratio depreciation is exacerbated by our current personal financial obstacles, as the modern era's flattening income

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<sup>5</sup> Fiscal Commission, p. 12

<sup>6</sup> CBO (March 2011, p. 12)

<sup>7</sup> Pgpf.org (11/8/10)

<sup>8</sup> Williams (4/22/09), Pgpf.org (11/8/10), Reason.com (11/29/10)

<sup>9</sup> Fiscal Commission, p. 49

averages for working Americans<sup>10</sup> will have an increasingly negative impact on yearly FICA contributions.

Overall, there is no foreseeable path for Social Security that can evade the requirement of either generating greater tax revenues or decreasing benefits, or both. If the first option is attempted through further increases in general FICA rates, the development would be highly concerning given that FICA is the most regressive of all federal taxes. With income on all wage and salary earnings above \$106,800 exempt (for the Social Security portion), this is a tax which, if significantly increased, would exacerbate the financial burdens on lower-income workers and businesses. Significant spending cuts to the program would be highly detrimental to many elderly recipients who rely heavily on these benefits for everyday expenditures. Other policy options include raising the taxable earnings cap, and increasing the retirement age.

As a result of this spike in Social Security payment obligations, combined with the systemic stagnation of current wage and salary contributions to the Social Security trust fund, most experts have projected consistent deficits for the fund to begin around 2015. In fact, as *Fortune* editor Allan Sloan points out, the \$41 billion Social Security deficit in 2010, first since the 1980s and largest ever, “means the Treasury will have to borrow money to redeem some of the trust fund’s Treasury securities.”<sup>11</sup> Certainly the particularly bleak economy at this point in time played a large part in this earlier-than-expected deficit in the trust fund; however, with a \$2.54 trillion fund (as of 2010), Sloan surely sounds prescient with the assertion that “When Social Security’s cash deficits begin running more than \$100 billion a year within a decade, it’s going to take a lot of money to keep the checks coming.”<sup>12</sup>

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<sup>10</sup> Reich (2007), p. 106

<sup>11</sup> Sloan (8/10/10)

<sup>12</sup> Sloan (8/10/10)

As concerning as the Social Security numbers are, they pale in comparison to the fiscal challenges presented by Medicare. A record 2.8 million citizens will qualify for the program in 2011 alone, and this number is expected to steadily increase for the next two decades.<sup>13</sup> In fact, by 2030 the program is projected to increase from 47 million enrollees to 80 million, even factoring in the expected mortalities, and by that time the worker-to-beneficiary ratio is expected to decrease from 3.4:1 to just 2.3:1. By 2020, the program is expected to cost \$929 billion, an 80 percent increase from the present cost.<sup>14</sup> The combined spending of Medicare and Medicaid, measured as a percentage of the economy, is expected to double by 2030.

It is a telling truth that obligatory Medicare payments have already been too large to be covered by payroll tax revenue. Contrary to the aforementioned Medicare part A, parts B and D are funded by general revenues. Part B includes doctor visits and other extended health services from the basic hospital insurance of part A, while Medicare part D is the prescription drug program signed into law in 2003 by the Bush administration. Therefore, the sustainability problem is not merely a demographic phenomenon about to burst with the retirement of baby boomers, but a fundamental inability for promised benefits to be covered by the government without drawing largely from general revenues.

There is strong statistical evidence for the great degree to which Medicare benefits are outsized relative to the contributions of taxpayers. An average couple, together earning \$89,000 in today's dollars over their careers, would pay \$114,000 into the system. Yet, they could still expect to receive \$355,000 worth of Medicare services- ranging from hospitalization to drug benefits- during their time as recipients, a total which more than triples their combined lifetime

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<sup>13</sup> Wolf (12/30/10)

<sup>14</sup> Wolf (12/30/10)

contributions.<sup>15</sup> There are many factors which enter into the calculation of this “average scenario”, such as the rising costs associated with health care in general and widely-variant needs for treatment amongst Medicare recipients. Undoubtedly, there are many citizens who ultimately do not utilize such a high amount of total benefits relative to their lifetime contributions.

However, such average statistical figures are the most accurate means by which we can evaluate the fiscal balance of a program. If there are any doubts as to the validity of this measure, and its conclusion of insufficiency regarding the funding of Medicare, the fact that the program *already* must draw largely from general revenues should put such doubts to rest.

### **The Tax System: Complexity, Inequity, and Inefficiency**

The difficulties regarding the U.S. tax code have been a topic of considerable debate and frustration for decades. In his 1976 acceptance speech for the Democratic nomination for President, Jimmy Carter described the tax code as “a disgrace to the human race.” As of 2006, the U.S. code of Federal Regulations, written by the IRS, was 13,458 pages long.<sup>16</sup> As of 2008, the IRS employed 115,000 people, had an \$11 billion budget, and sent out 8 billion pages of forms and instructions annually.<sup>17</sup> By one estimate, American taxpayers spend 6.1 billion hours annually in the effort to file taxes.<sup>18</sup> Additionally, the aggregate national tax compliance effort is believed to cost Americans at least \$110 billion annually, which is roughly 10 cents for every dollar of revenue raised.<sup>19</sup> And, despite all of this machinery and effort, it is estimated that one of six tax dollars owed still goes unpaid each year.<sup>20</sup>

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<sup>15</sup> Alonso-Zaldivar (12/30/10)

<sup>16</sup> Gordon (2010), p. 117

<sup>17</sup> Laffer et al. (2008), p. 243

<sup>18</sup> Riley (1/5/11)

<sup>19</sup> Slemrod and Bakija (2004), p. 4

<sup>20</sup> Hacker and Pierson (2010), p. 50

This is a shining example of what economists refer to as a deadweight loss. Indeed, if we adhere to the dictates of sheer logic, how is it possible to conclude that all of this human effort to comply with the tax code is not a waste, or at least a severe drag on our national potential? After all, it is not just the ratio of time spent complying with the tax code versus the value of tax refunds that is important to scrutinize; there is also the immense cost of maintaining the modern IRS, the amount of money spent on tax specialists, accountants, and lawyers in the effort to capitalize on tax breaks, and the often devastating tax compliance costs to American businesses—which can prevent them from contributing to the economy what their potential would suggest in the absence of such tax burdens.

Whereas there are always differing opinions regarding the impact of the federal budget on the broader economy, the tax complexity issue is directly and unambiguously produced by the fiscal decisions our elective representatives decide to make. Therefore, in principle these great complexities and inefficiencies can clearly be alleviated by the legislative mechanisms at our disposal. However, this task has proven to be quite difficult in practice, and it is incumbent upon our study to examine why.

The primary reason why the federal tax code has not been simplified is very blunt and clear: the interests of the few who stand to gain from a particular exemption or deduction are so strong, and the opposition so diffused among the rest of the citizenry (and therefore muted), that well-funded interests can easily lobby politicians into maintaining loopholes and carving out new tax breaks. Even the one great example we have of a Congress coming together to root out a large share of these unnecessary and costly tax exceptions, that of the Tax Reform Act of 1986, was immediately followed up by a return to business as usual: “Just in the ten years after the 1986 major simplification of the tax code... the code was amended no fewer than 4,000 times, a rate

better than one amendment a day.”<sup>21</sup> It takes a brave legislator indeed to resist the efforts of corporations and interest groups to secure preferential tax breaks when these entities are often the funding lifeblood of political campaigns. Given the lack of an informed and mobilized opposition to the general process of creating “tax expenditures”, this practice has unfortunately proliferated in the modern political era and, at the federal level, is threatening to sack the Treasury of the ability to cover vital expenditures.

Tax expenditures, according to Congressman John Tierney, are “subsidies, tax credits, deductions, exclusions, exemptions and special preferential rates for individuals, business and corporations hidden in the tax code in that, once enacted, they do not have to be reauthorized or included in annual appropriations legislation.”<sup>22</sup> Some examples are: carried interest, whereby the compensation of investment managers is taxed at the lower capital gains rate (15%) than the standard income rate (35%); the tax-free status of employer-provided health insurance; agricultural subsidies; tax credits for ethanol; and countless other tax exceptions, some of them utterly obscure and insignificant to broad public concerns. As tediously narrow as many of these categories may seem, the aggregate number and effect of tax expenditures is no small matter. The total pecuniary value of U.S. tax expenditures, and thus the dollar figure which the Treasury must forego to these tax breaks, now registers at \$1.1 *trillion* annually.<sup>23</sup>

It is instructive, if utterly confounding, to reflect on the nonstop budget drama of early 2011 to fund the federal government throughout the rest of the fiscal year. That so much partisan maneuvering and deadlock regarding the budget- and real-life anxiety and disappointment for federal workers- could be perpetuated for weeks on end, was an unfortunate sight for many onlookers. Yet, upon recognition that the only part of the budget which suffered was the lone

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<sup>21</sup> Gordon (2010), p. 195

<sup>22</sup> Tierney (4/19/11)

<sup>23</sup> Hanlon (2/14/11)

target where the Republican House majority pushed for cuts, that of the domestic discretionary budget (which was cut to the tune of \$39 billion), we are left with a painfully clear example of how unstoppable the other budget areas have become. The entrenchment of entitlement and defense spending are well known and major topics of national debate; however, with \$1.1 trillion worth of tax breaks more than *doubling* the domestic discretionary budget<sup>24</sup>, the omission of any corresponding cuts to the tax expenditure side of the budget is inexcusable.

The role of campaign finance in maintaining such a massive web of tax breaks cannot be overlooked. In the modern era, with the ascendance of television and the greatly increased funding it has necessitated for success on the campaign trail, politicians' electoral prospects are ever more dependent upon the most well-funded interests.<sup>25</sup> However, this issue is not merely about the necessities of campaign funding and the inordinate clout of modern interest group politics. For a balanced look at the forces through which the tax system has become riddled with expensive depletions, we must also consider the impact of tax burdens on individual and corporate behavior.

One primary reason why many corporations and individuals have incentive to go to such great lengths in the avoidance of taxes is that there are so many opportunities in the modern era to do so. Globalization and capital mobility have made it far more feasible for many corporations to find the most tax-preferential areas, either around the U.S. or offshore, to base company operations, outsource production of specific goods or services, and shelter profits. As damaging as these activities can be for local communities, domestic industrial sectors, and for the nation's tax base as a whole, this general process raises difficult questions about what should be done in response.

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<sup>24</sup> Hanlon (2/14/11)

<sup>25</sup> Hacker and Pierson (2010), p. 171

The marquee example of this difficulty is the state of the corporate income tax. This tax, which produced consistently strong revenues to the tune of 6 percent of GDP half a century ago, mustered revenues equal to just 2.1 percent of GDP just before the financial crisis of 2008.<sup>26</sup> Another study concluded that the share of overall federal revenues produced by the corporate tax dropped from 30 percent in the 1950s to just 6.6 percent in 2009.<sup>27</sup> This is a massive drop in the revenue production of an important federal tax. According to a 2007 Treasury Department study, the U.S. combined (federal and state) statutory corporate tax rate of 39 percent was the second highest amongst the 30 member nations of the Organization for Economic Cooperation and Development (OECD), exceeding the average rate of 28.4 percent by nearly 11 percent.<sup>28</sup> Yet, despite these higher rates, U.S. corporate tax revenues equaled just 2.2 percent of GDP from 2000 to 2005, while the OECD average nation produced 3.4 percent of GDP in such revenues. How did all of this come about? For one, maintaining such a high corporate income tax rate while most competitor nations have been decreasing theirs, has greatly exacerbated the temptation for U.S. companies to move operations and profits overseas. In one well-publicized example, Google managed to achieve a total overseas tax rate of just 2.4 percent in 2009, despite the fact that the vast majority of their overseas operations and profits are managed in nations with corporate tax rates well over 20 percent.<sup>29</sup> One primary way that Google and other companies achieve these amazingly low effective tax rates is through transfer pricing; these are “paper transactions among corporate subsidiaries that allow for allocating income to tax havens while attributing expenses to higher-tax countries. Such income shifting costs the U.S.

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<sup>26</sup> Williams (4/22/09)

<sup>27</sup> Kueber (3/28/11), Kocieniewski (3/24/11)

<sup>28</sup> Merrill, 3/15/11

<sup>29</sup> Drucker (10/21/10)

government as much as \$60 billion in annual revenue, according to Kimberley A. Clausing, an economics professor at Reed College in Portland, Oregon.”<sup>30</sup>

In the U.S., Google still paid an overall effective tax rate of 22.2 percent in 2009, yet this percentage still obviously fell well short of the statutory corporate tax rate. However, other companies have been able to achieve much lower effective corporate tax rates. After capitalizing on a “maze of shelters, tax credits and subsidies”, General Electric ended up with an effective tax rate of *zero* in 2010.<sup>31</sup> The New York Times reported that G.E. registered a 7.2 percent effective U.S. tax rate this past year, but being that these tax obligations are comprised of overseas profits and will not be taxed unless brought back home, as of now the company can claim a 2010 tax *benefit* of \$3.2 billion.<sup>32</sup> Google and G.E. are by no means the only companies who greatly profit from this enhanced atmosphere for tax preference and profit sheltering. However, these two rather striking examples show just how much capacity modern corporations have to avoid taxation; and how costly the government “drift”, or inaction, can be, echoing the concerns of Hacker and Pierson.

Ultimately, our analysis of taxes boils down to long-term revenue production and effects on the private economy. And by either measure, the system has not been productive or fair in the modern era. As Figure 3 indicates below, tax revenues have remained nearly constant as a percentage of GDP, lingering in the average range of 18 percent consistently for the past 60 years.<sup>33</sup> What is most startling about this process is how much the chief revenue producer, the personal income tax, has fluctuated in its rates in the same period. Whether the top marginal rate was 91 percent in the 1950s or 35 percent in the 2000s, revenues stayed roughly the same.

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<sup>30</sup> Drucker (10/21/10)

<sup>31</sup> Kocieniewski (3/24/10)

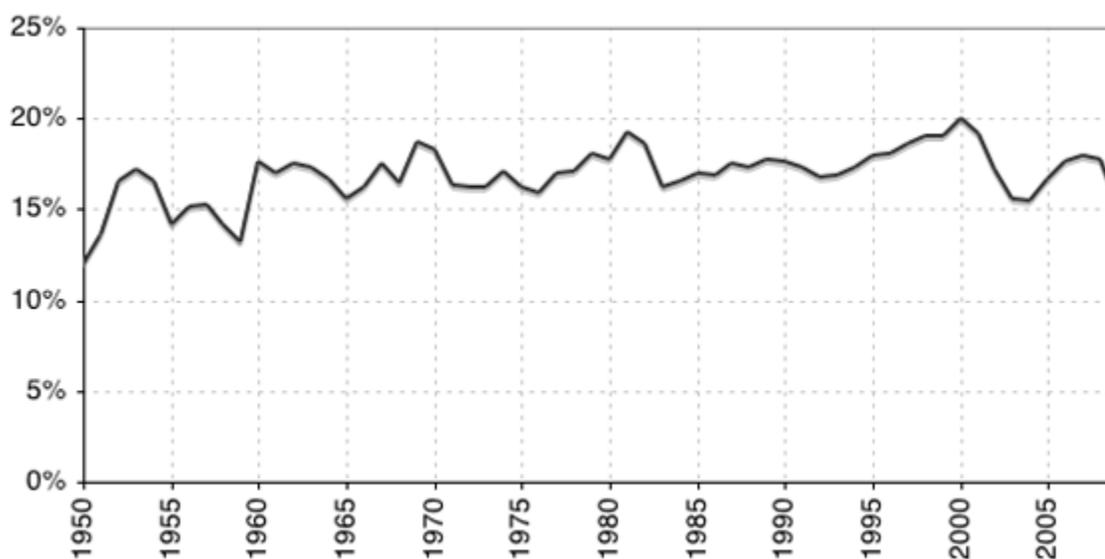
<sup>32</sup> Kocieniewski (3/24/11)

<sup>33</sup> Williams (4/22/09), pgpf.org (11/8/10)

**Figure 3- Total Federal Tax Revenues as a Percentage of U.S. GDP since 1950**

Y-axis- tax revenues as a percentage of GDP

X-axis- year



Source: <http://www.deptofnumbers.com/blog/2010/08/tax-revenue-as-a-fraction-of-gdp/>

The reason that such variant tax rates can produce such consistently similar revenue totals is two-fold. The first explanation is the aforementioned problem of the thousands of exceptions written into the tax code, and the tremendous shrinking of the tax base that accompanies them; this is a process for which the incentive to avoid taxes is exacerbated by higher tax rates. As a result of this dynamic, high nominal tax rates are often not indicative of, and even downright irrelevant to, the actual tax revenues collected. The second explanation is that other taxes have to fill the void when the individual and corporate income taxes are not sufficient to produce adequate revenues. This means that policymakers must target highly reliable revenue sources where, contrary to the

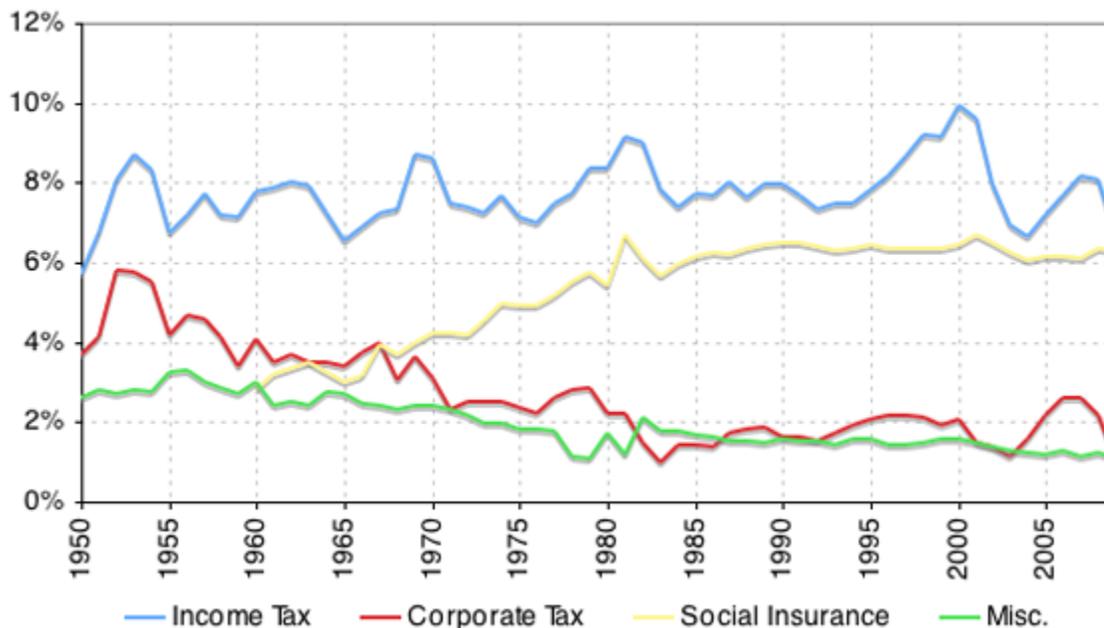
volatility of income tax compliance, revenues can most assuredly be collected: unfortunately, this has entailed a greater reliance on the wage and salary income of working Americans.

Figure 4 below reveals to us in clear terms the painful reality of this concerning trend regarding the strained national capacity for attaining tax revenue. While corporate income tax revenues have plummeted tremendously in the past 60 years, and individual income tax revenues have remained largely constant, payroll revenues, emanating from the most regressive of all federal taxes, have nearly tripled as a percentage of GDP. There are other factors involved in this trend, such as the need to pay for increases in Social Security benefit obligations. However, regardless of the destination of these funds, it defies logic to argue that the workers and businesses who suffer most in times of economic struggle should be subjected to a tripling of the effective corporate tax burden (in GDP terms), and a nearly equal burden to the aggregate personal income tax pool.

**Figure 4- Breakdown of Federal Tax Revenue Changes since 1950**

Y-axis- tax revenues as a percentage of U.S. GDP

X-axis- year



Source: <http://www.deptofnumbers.com/blog/2010/08/tax-revenue-as-a-fraction-of-gdp/>

One of the most widely-lamented facts about the post-1970s American economy is the trend of increasing economic inequality. This is a phenomenon which has been observed in many other nations as well. The diagnosis for this issue is complicated by the roles of globalization and technological advancement, and by changing household dynamics (especially when such inequality is measured by median household income). However, Krugman and Reich are correct to point to government responsibility as well. A three-decade era of higher-income tax cuts and significantly increased payroll taxation has certainly played a part in widening the gap between the wealthiest citizens and everyone else.

## Conclusion

The major burden of this study has been to provide a picture of the key developments of U.S. fiscal history which can help us better understand the critical juncture we have reached regarding the state of the nation's public finances. In chapter two we identified the consequences of the financial crisis of 2008, while in chapter three we examined the differing economic philosophies which have governed U.S. politics and the political-economic literature for decades. In chapter four we considered a long-run analysis of U.S. fiscal and economic history in order to evaluate the claims of the authors featured in our literature review, and to reflect on the significance of the great recession and current fiscal stress. Lastly, in chapter five, we took a closer examination of the root causes of the emerging fiscal crisis.

Upon examination of this picture, it is clear that the two primary fiscal challenges that this country faces are rising health and social insurance costs and a tax code which is too complicated, does not produce revenues sufficient to fund the modern development of the government, and has unfairly saddled working Americans with financial burdens that we have become increasingly strained to meet.

As the nation decides on long-term solutions to this emerging fiscal crisis, it is imperative that we consider the lessons of our fiscal and economic history, and that we avoid the mistakes of dogmatic attachment to political-economic theories which have been appropriate to address one challenge, yet remain wholly unsuited for others. In this thesis, we have illuminated such dogmas in the case of Andrew Jackson's crusade against central banking in the 1830s, the inflationary over-reliance on Keynesian fiscal and

monetary policies in the 1970s, and the deficit-producing ideology of tax cuts spurred by Reaganomics in the post-1980 era. None of these philosophies were devoid of logic, but each had its limits, and it is precisely such limits which we must keep in mind when searching for policies to address the emerging fiscal crisis.

The bottom line is that the U.S. government must find a way to significantly increase tax revenues without saddling the citizenry with counterproductive and unfair tax burdens. In the absence of such revenue increases, it will not be possible to pay for the spike in Medicare and Social Security benefits which is now under way and will represent a major challenge for decades. In light of chapter four's comprehensive analysis of the history of our national income tax system, it is clear that the most efficient and equitable manner at our disposal to begin these imperative revenue gains is to reform the system's litany of tax expenditures.

If there is one fiscal reform topic which, at least in principle, Americans of all political persuasions could agree, it is the need to fundamentally reform the nation's tax system. We have discussed the unfortunate factors which keep this system intact, but it is incumbent upon the citizenry to do what is best for the long-term health of the country; and there could be no clearer example of an area needing reform. We have seen the powers of tax simplification at work with the Tax Reform Act of 1986, where the elimination of tax loopholes and preferences, and the resulting revenue increases, were so comprehensive that they allowed for the top marginal income tax rate to be decreased from 50 to 28 percent. A similar reform plan today could eliminate hundreds of billions of dollars annually from the expected budget deficits of the next several years, help reverse the concerning trend of increased tax burden inequities, and bolster American

business tremendously through the increased competitiveness accompanying lower tax rates and by eliminating the economic distortions which force businesses to make decisions based on such complicated tax considerations.

President Obama's Fiscal Commission made an admirable attempt to do just that in December 2010. The National Commission on Fiscal Responsibility and Reform, led by former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles, created a proposal for long-term deficit reduction which projected a \$785 billion cut to tax expenditures between 2012 and 2020. Additionally, the Commission proposed a wide range of gradually-increased spending reductions across the board of the discretionary budget, and proposed preliminary entitlement reforms for a total projection of \$3.8 trillion in budget savings throughout the rest of the decade. The plan was not perfect, but nothing will be: it represented a sensible and comprehensive approach to gradually reduce deficits to the point where the country would not have to worry about an impending debt collapse, would not have to suffer through as many nonsensical and economically damaging tax burdens, and with the fiscal and economic improvement under such conditions, would finally be able to address the long-term sustainability crisis within entitlement spending.

However, this far-reaching fiscal reform effort was neither given the authority for a Congressional vote in the initial process (which prompted President Obama's executive order creating the Fiscal Commission), nor was the final plan even supported by the supermajority of Commission members necessary to elevate it to the legislative process. Thus, it appears that we will have to continue waiting for any prospect of the true fiscal reform that the country needs to move forward.

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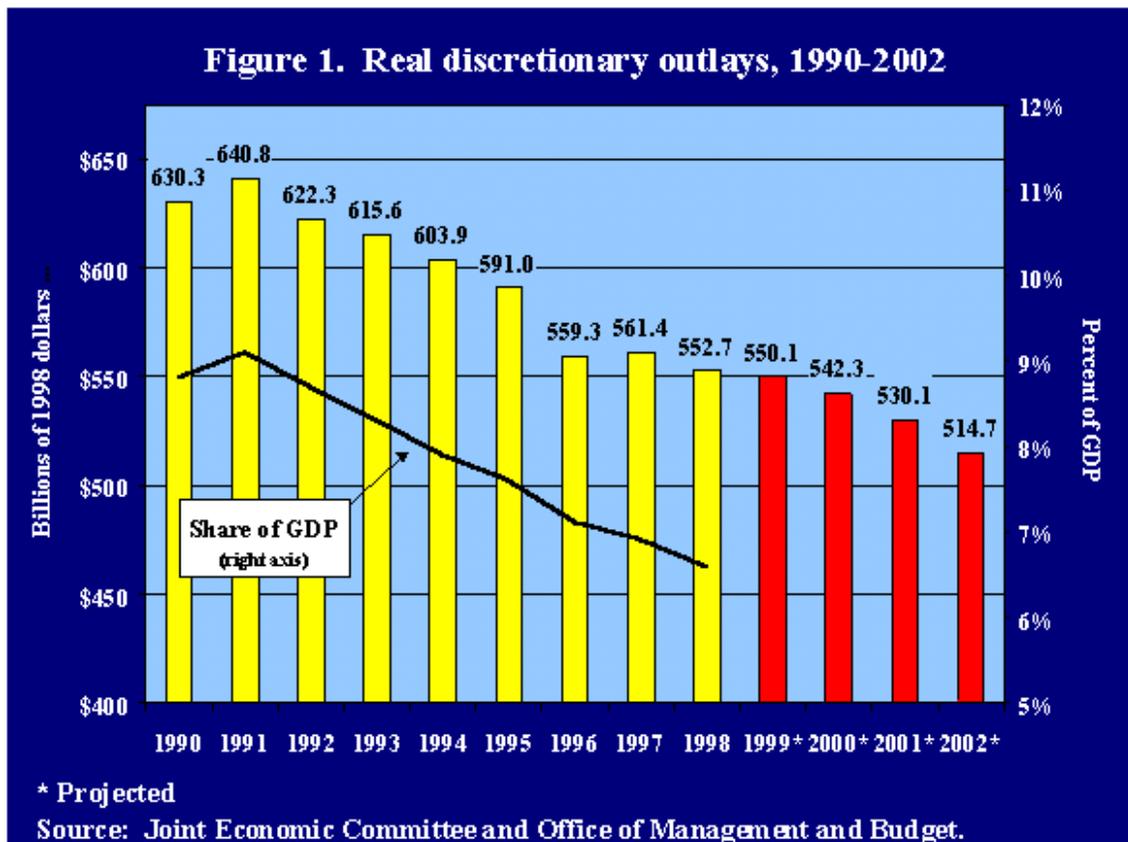
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## Appendix A

### List of Figures

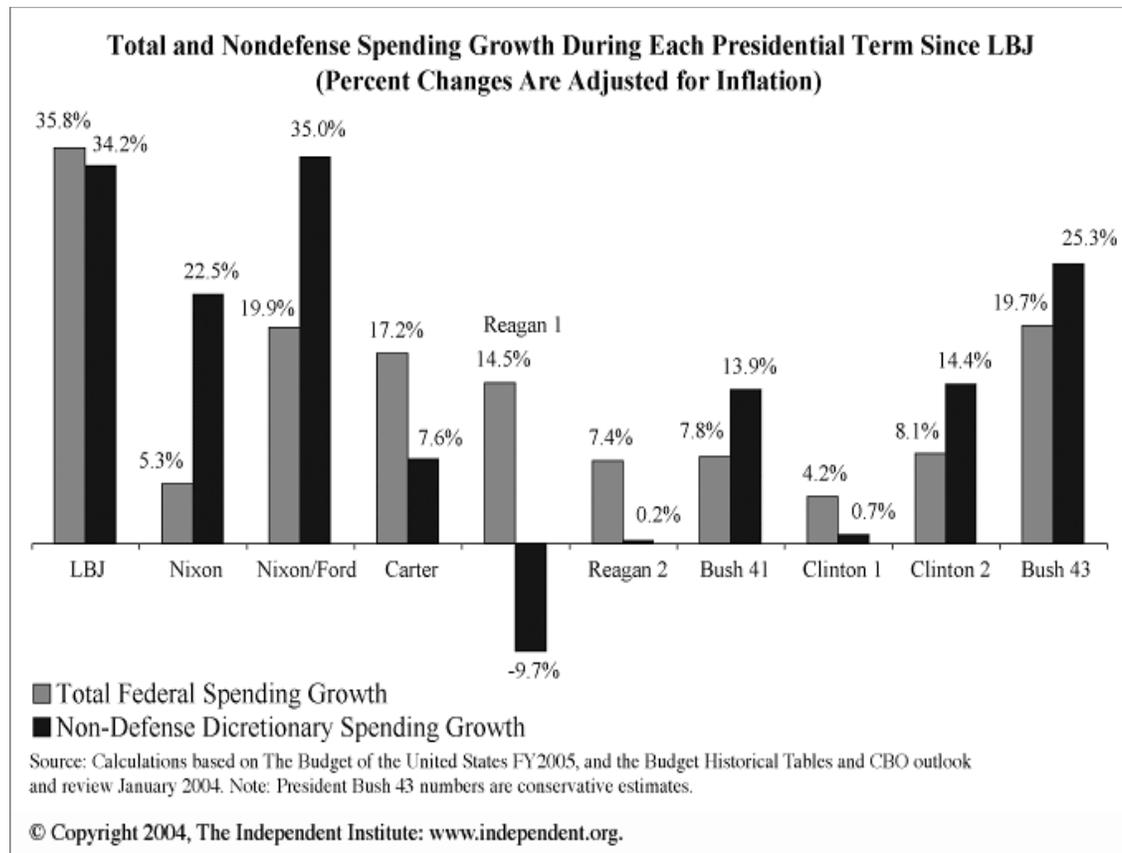
Figure 1- Federal Discretionary Spending Reductions from 1990 through 2002



Source: Congressional Budget Office

<http://www.house.gov/jec/fiscal/budget/restrain/fig-1.gif>

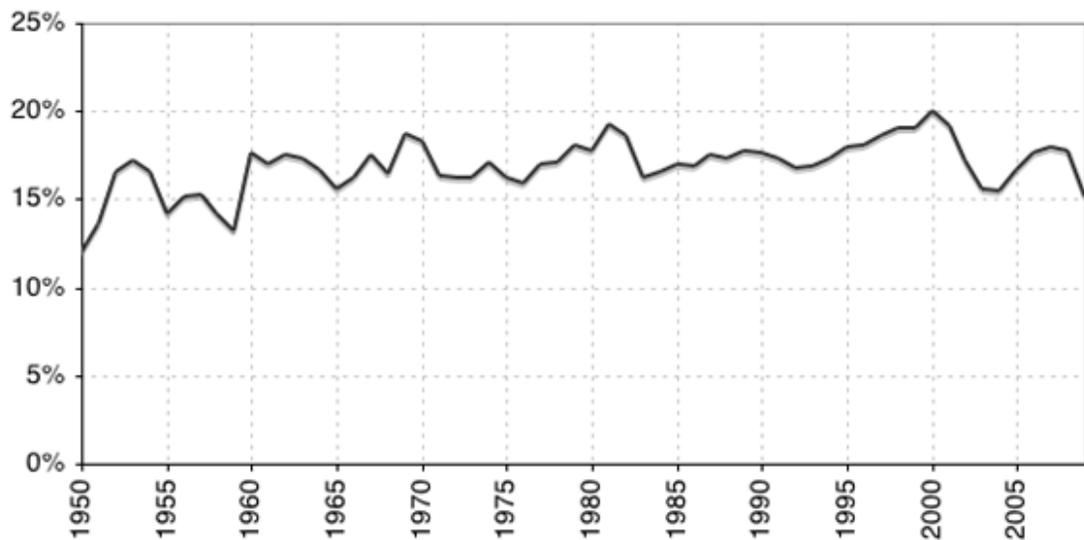
Figure 2- Federal Spending Growth by Presidential Term since Lyndon Johnson



Source: *The Independent Institute*.

[http://www.independent.org/newsroom/news\\_detail.asp?newsID=31](http://www.independent.org/newsroom/news_detail.asp?newsID=31).

Figure 3- Total Federal Tax Revenues as a Percentage of U.S. GDP since 1950  
 Y-axis: tax revenues as a percentage of GDP  
 X-axis: year



Source (for both graphs): *Department Of Numbers*.

<http://www.deptofnumbers.com/blog/2010/08/tax-revenue-as-a-fraction-of-gdp/>

Figure 4- Breakdown of Federal Tax Revenue Changes since 1950  
 Y-axis: tax revenues as a percentage of U.S. GDP  
 X-axis: year

