

Commentary

## Even Reagan Raised Taxes

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### **Obama is following the paths of former presidents when it comes to balancing the budget.**

It's budget week in Washington, and the \$1.27 trillion deficit projected for fiscal 2011 should remind us that deep recessions, especially when accompanied by large spending sprees, produce outsized deficits ] for years to come. The federal government has been down this road recently before, first under Ronald Reagan and then George H. W. Bush and Bill Clinton. The way those presidents responded can help us chart the likely path of fiscal policy for the next half decade.

Presidential budgets are always a little overwhelming. Barack Obama's, for example, has a surprising number of proposals usually seen in Republican budgets--new tax breaks for business, including ending capital gains tax on new investments in small businesses; a freeze on large areas of discretionary spending; termination of some 120 small federal programs; and increases in military spending. Less unexpected, Obama's budget brings back proposals from past Democratic plans, including big spending increases for higher education, infrastructure and research and development; tax hikes for big banks, big oil and big coal; and higher tax rates for high-income people (by letting the Bush tax cuts for top earners expire and by cutting back carried interest).

More notable is Obama's emerging commitment to long-term fiscal restraint. This seems evident not only in his proposals for spending cuts, but also in his calls to bring back the "pay-as-you-go" rules, which make Congress pay for any new initiative with spending cuts or tax increases, and create a bipartisan commission to reduce entitlement spending. Senate Republicans moved to block both initiatives, even though pay-as-you-go was a key element of the Clinton-GOP budget entente that briefly balanced the budget and every GOP president since Reagan has supported entitlement commissions. But these early skirmishes are unlikely to alter the long-term path of fiscal policy.

The realities of global capital markets will largely set this path--much as they have in the past. When these markets see a long string of unsupportable deficits, they respond by pushing up long-term interest rates and driving down the value of the currency. Both of these developments have already begun to unfold, which may help explain Obama's new concern for fiscal probity. But the prospect of a sinking economy will make almost any president shift course, and when they do the budget and the politics surrounding it provide a limited number of pathways.

The first part of that path entails raising higher revenues. Everyone remembers Reagan's 1981 tax cuts. His admirers are less likely to tout the tax hikes he accepted as the 1981 recession and his own tax cuts began to unravel his long-term fiscal picture--a large tax increase on business in 1982, higher payroll taxes enacted in 1983 and higher energy taxes in 1984. A decade later, when a serious recession and higher spending began to upend the fiscal outlook again, the first President Bush similarly raised taxes on higher-income people in 1991; Bill Clinton doubled down and raised them again in 1993.

Presidents facing the prospect that unending deficits will undo their economic legacies also cut spending in the only places that make a big difference, starting with defense. Reagan is remembered, again, for his defense build-up--but his big increases in Pentagon spending ended by 1985. Similarly, the first President Bush increased the military to fight the first Gulf War. But before he left office Pentagon spending was slowing sharply with the end of the Cold War, and Clinton followed by cashing in on the peace dividend.

Here we are again, with a sharply deteriorating deficit outlook driven by a deep recession and the steps taken to alleviate it, as well as by higher wartime spending. Over the next several years, President Obama will follow the same path as Reagan, Bush-41 and Clinton--because global capital markets will leave him and us no alternative. We will raise substantial new revenues, whether it's justified by climate change (by auctioning greenhouse gas permits or applying carbon-based taxes) or the looming insolvency of Medicare and Medicaid. Defense spending will also slow significantly, presumably as we wind down our military engagement in Iraq and, one hopes, Afghanistan as well.

The Reagan and Clinton strategies also slowed new spending in the other huge and growing area of the federal budget, health care; and Obama has pushed reforms to do the same. But his task here will be much harder, because his own agenda also promises to reduce the numbers of uninsured at considerable cost. Yet, if you want to gauge the President's current priorities, given the choice of broader health care coverage and the prospects for the economy, look to last week's State of the Union address, when he devoted 40 minutes to the economy and less than five minutes to health care. For this president, much like his predecessors, the economic outlook for average Americans ultimately trumps just about everything else.

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