Deficits, Debt, and the New Politics of Tax Policy

The Constitution grants Congress the power "to lay and collect taxes, duties, imposts, and excises." From the First Congress until today, conflicts over the size, role, and taxing power of government have been at the heart of national politics. This book provides a comprehensive historical account of federal tax policy that emphasizes the relationship between taxes and other components of the budget. It explains how wars, changing conceptions of the domestic role of government, and beliefs about deficits and debt have shaped the modern tax system.

The contemporary focus of this book is the partisan battle over budget policy that began in the 1960s and triggered the disconnect between taxes and spending that has plagued the budget ever since. With the federal government now facing its most serious deficit and debt challenge in the modern era, partisan debate over taxation is almost completely divorced from fiscal realities. Continuing to indulge the public about the true costs of government has served the electoral interests of the parties, but it precludes honest debate about the urgent task of reconnecting taxes and budgets.

Dennis S. Ippolito is Eugene McElvaney Professor of Political Science at Southern Methodist University. Among his previous books are *Why Budgets Matter: Budget Policy and American Politics*, *Uncertain Legacies: Federal Budget Policy from Roosevelt through Reagan*, *Hidden Spending: The Politics of Federal Credit Programs*, *Congressional Spending*, and *The Budget and National Politics*. He was awarded the 2010 Aaron B. Wildavsky Award for Lifetime Scholarly Achievement in the Field of Public Budgeting and Finance.

Deficits, Debt, and the New Politics of Tax Policy

DENNIS S. IPPOLITO
Southern Methodist University

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town,
Singapore, São Paulo, Delhi, Mexico City

Cambridge University Press
32 Avenue of the Americas, New York, NY 10013-2473, USA

www.cambridge.org
Information on this title: www.cambridge.org/9781107641402

First published 2012

Printed in the United States of America

A catalog record for this publication is available from the British Library.

Library of Congress Cataloging in Publication Data

Ippolito, Dennis S.
Deficits, debt, and the new politics of tax policy / Dennis S. Ippolito.
p. cm.
ISBN 978-1-107-01727-6 (hardback) – ISBN 978-1-107-64140-2 (paperback)
1. Fiscal policy – United States. 2. Finance, Public – United States. 3. Taxation – United States – History. I. Title.
HJ257.3.I67 2012
336.73–dc23 2012029079

ISBN 978-1-107-01727-6 Hardback
ISBN 978-1-107-64140-2 Paperback

Cambridge University Press
978-1-107-01727-6 - Deficits, Debt, and the New Politics of Tax Policy
Dennis S. Ippolito
Frontmatter
More information

To Melanie Kay

Cambridge University Press
978-1-107-01727-6 - Deficits, Debt, and the New Politics of Tax Policy
Dennis S. Ippolito
Frontmatter
More information

Contents

Cambridge University Press
978-1-107-01727-6 - Deficits, Debt, and the New Politics of Tax Policy
Dennis S. Ippolito
Frontmatter
More information

Figures and Tables

Figures

Tables

Preface

> As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible . . . but remembering also that timely disbursements to prepare for danger frequently prevent much greater disbursements to repel it. . . . The execution of these maxims belongs to your representatives, but it is necessary that public opinion should co-operate. To facilitate to them the performance of their duty, it is essential that you should practically bear in mind that towards the payment of debts there must be revenue; that to have revenue there must be taxes; that no taxes can be devised which are not more or less inconvenient and unpleasant; that the intrinsic embarrassment, inseparable from the selection of the proper objects (which is always a choice of difficulties), ought to be a decisive motive for a candid construction of the conduct of the government in making it, and for a spirit of acquiescence in the measures for obtaining revenue, which the public exigencies may at any time dictate.
>
> George Washington's Farewell Address, 1796

Tax policy provides illuminating perspectives on politics, particularly in the United States. Perhaps the most resonant protest leading to the American War for Independence was the colonists' denunciation of taxation without representation, and taxation has continued to spark political conflict ever since. From the early battles between Hamiltonians and Jeffersonians to the contemporary partisan clashes over taxes and "big government," tax policy has helped define American parties and shape American political development.

The economic stakes associated with taxes have likewise engaged interest groups throughout our history. Issues of fairness and economic impact have been repeatedly contested, with policymakers struggling to apply these and other prescriptive criteria to the complex provisions of an ever-expanding tax code. Because taxation continually engages the public in a way that few, if any, public policies do, the electoral salience of tax issues has often played an important part in presidential and congressional elections.

In the United States, the relationship between taxation and the other components of the budget – defense and domestic spending, along with deficits and debt – has also been an explicit and oftentimes contentious issue as well. A number of excellent studies have examined how major wars have ushered in lasting changes in the types of taxes that Americans pay and the amount of revenue that government demands. Indeed, with the exception of the recent wars in Iraq and Afghanistan, the decision to go to war has inevitably led to the enactment of new or special taxes. The individual income tax, for example, was first imposed during the Civil War, expanded into a major revenue source during World War I, and transformed into a mass tax in World War II. It has supplied the largest share of federal revenues ever since.

Wars do not provide the entire explanation, however, for long-term changes in tax policy. The Social Security Act of 1935 introduced payroll taxes to fund benefits for retired workers, and these and other social insurance taxes now provide more than one-third of the federal government's annual revenues. Social Security and Medicare are the largest of some two dozen social welfare entitlement programs that today account for more than half the federal budget and will likely absorb an even larger share in the future. With the federal government having taken on social welfare responsibilities for the elderly and the poor, taxation has become an important instrument of social policy and a critical part of the debate over the welfare state.

The purpose of this book is to analyze federal tax policy in this budget policy context. It provides a comprehensive historical account of how wars, changing conceptions of the domestic role of government, and attitudes toward deficits and debt created the modern tax system in the United States. It then focuses on the causes and consequences of the partisan disconnect between spending and revenue policy that has taken hold over the past several decades and remains firmly in place despite the unprecedented deficit and debt problems the nation now faces.

The revenue/spending/deficit-debt nexus explored in this book is not, in other words, simply a contemporary phenomenon. There was no federal budget as such in the 1790s, but there was nevertheless a remarkably comprehensive debate about the level and type of federal taxes, constitutionally permissible spending, the propriety of deficits, and the management of debt. For Thomas Jefferson and his followers, Federalist "High Finance" was anathema, and their political ascendancy after 1801 ushered in a very different fiscal vision for the federal government.

These early partisan battles over taxation (mainly tariffs and excises), spending (particularly "internal improvements"), and balanced budgets continued throughout the nineteenth and early twentieth centuries. Under the Republican Party that dominated the post–Civil War period, a new spending philosophy was introduced, funded by high protective tariffs and permanent excise taxes. As concerns grew about the fairness, economic distortions, and revenue

Cambridge University Press
978-1-107-01727-6 - Deficits, Debt, and the New Politics of Tax Policy
Dennis S. Ippolito
Frontmatter
More information

capacity of this tax system, proponents of income taxation finally succeeded in passing the Sixteenth Amendment and reinstating the federal income tax.

Even under Republicans, however, federal spending remained extremely low by modern standards. When the federal government published its first comprehensive report on government finances in 1902, state and local spending was approximately 5 percent of gross domestic product (GDP), while the federal budget was well below 3 percent. From 1789 to 1930, moreover, balanced-budget principles generally ensured that national taxation satisfied its basic purpose – adequately funding the public programs that "provide for the common defense and general welfare of the United States." Federal budgets were usually balanced – the major exceptions being wars – and federal debt was usually quite low.

The era of modern budget policy began in the 1930s as budgets became much larger – spending was about 3 percent of GDP in 1930 and more than 15 percent two decades later. During the 1950s, with Cold War defense spending accounting for well over half of the budget, federal spending–GDP levels climbed to nearly 20 percent. And while Democratic versus Republican differences over tax policy certainly were evident, they were moderated by a strong bipartisan commitment to balanced budgets. In the fifteen-year period from the end of World War II through the Truman and Eisenhower administrations, budgets were balanced seven times, and deficits were tightly controlled. By 1961, the publicly held debt–GDP ratio had dropped to 45 percent, compared to nearly 110 percent after World War II.

As these figures suggest, revenue levels closely tracked spending over this period, while tax policy remained quite stable. The steeply progressive rate structure of World War II – 23 percent to 94 percent, with twenty-four income brackets and very low personal exemptions – remained largely in place for nearly two decades. Both the Truman and Eisenhower administrations resolutely subordinated tax policy to the financing requirements of an enormously costly Cold War defense program and a federal domestic role that preserved the New Deal's legacy.

The destabilizing of tax policy that began in the 1960s is the contemporary focus of this book. Over the past fifty years, the straightforward balanced-budget rule that had constrained tax policy change for much of our history has been modified to accommodate economic stimulus strategies, partisan spending priorities, and the electoral interests of increasingly competitive national parties. The disconnect between spending and revenues today is much larger than in recent decades and potentially much more damaging, but it is rooted in the very different partisan visions of federal budget policy that began to emerge in the wake of the Great Society.

Budgets were balanced only twice under the Kennedy and Johnson administrations, and deficit-GDP levels were about double the average for the 1950s. The Revenue Act of 1964, which cut income tax rates at all income levels, was an aggressive and largely successful effort to spur higher levels of economic growth, but when the Johnson administration launched the Vietnam War and insisted that the nation could also afford the Great Society, it sought to keep these tax cuts in place. In addition, Great Society initiatives were beginning to shift the spending side of the budget from defense to domestic programs even during the peak years of the Vietnam War. When congressional conservatives insisted on attaching domestic spending cuts to the temporary Vietnam War tax increase that was finally enacted in 1968, Lyndon Johnson fought doggedly to protect his spending priorities. By the end of Johnson's presidency, combined social welfare and other domestic spending accounted for nearly 50 percent of the budget, while the defense share was lower than it had been before the Vietnam War.

The disconnect between spending and revenues became even more pronounced during the 1970s as heavily Democratic Congresses steadily expanded the Great Society's domestic spending initiatives. Spending-GDP levels remained above 20 percent after the Vietnam War ended, with nearly half the budget devoted to social welfare programs. Congress attempted to pay for this "welfare shift" with defense cuts rather than tax increases, which seriously damaged important U.S. military capabilities and, at the same time, proved insufficient to offset the rapid rise in domestic spending. From 1970 to 1979, there were no balanced budgets, and deficit-GDP levels averaged almost 3 percent over the latter part of the decade. By the end of the Jimmy Carter presidency, Democratic hopes for a return to balanced budgets were predicated on revenue levels that exceeded those of World War II but somehow did not require the party to increase income taxes.

During the 1980s, deficit-GDP levels averaged more than 4 percent annually and the public debt rose from 26 percent of GDP to more than 40 percent. The Reagan tax cuts obviously contributed to this imbalance, but other budget policy dynamics also played an important role. In particular, social welfare entitlements continued to grow during the Reagan presidency. Increases in the defense budget – from 4.9 percent of GDP in 1980 to a peak of 6.2 percent in 1986 – were actually more than offset by cuts in nondefense discretionary spending, but overall spending-GDP remained high as retirement and healthcare entitlements expanded. During the 1960s and 1970s, entitlement growth had been financed largely through defense cuts. Under Ronald Reagan, these defense transfers were halted, and deficits quickly mounted.

Reagan-era spending dynamics had a dramatic impact on how Republicans and Democrats defined the balanced-budget problem. For Republicans, large deficits were caused by "excessive" domestic spending, and their stated goal was to balance budgets at low revenue levels (i.e., the 18-plus percent of GDP in Reagan's second term). Within this revenue level, moreover, individual income tax policy was their most important concern. The marginal rate cuts in 1981 (from a top rate of 70 percent to 50 percent) and 1986 (to 28 percent) were viewed by Reagan and most Republicans as the essential ingredient in long-term economic growth. In the face of large deficits, Reagan and congressional Republicans had agreed to corporate tax increases in 1982, 1984, and 1986 and to a significant increase in Social Security taxes in 1983, but Reagan repeatedly rejected efforts to raise marginal income tax rates, arguing that this would undermine economic growth.

Tax policy under Reagan, then, had a domestic retrenchment and economic growth rationale that have since become Republican orthodoxy. For Democrats, the deficit problem had very different implications for tax policy. First, Democrats needed to reduce deficits through higher revenue levels in order to protect the social welfare programs to which the party was committed. Second, this Democratic prescription for higher revenue levels was tied to individual income tax increases primarily for high-income taxpayers.

The paradigmatic budget battle of the Reagan years – whether to balance the budget at high or low revenue levels – was resolved in the 1990s with a heavy Democratic tilt. Individual income tax increases in 1990 and, especially, 1993 lifted revenue-GDP levels to nearly 21 percent by the end of the decade, with much but certainly not all of this additional revenue from high-income taxpayers. These were the highest revenue-GDP levels since World War II. As steep cutbacks in post–Cold War defense budgets reduced overall spending-GDP to its lowest level in more than three decades, the resulting fiscal turnaround was dramatic – from a $290 billion deficit in 1992 to a $236 billion surplus in 2000. The return of balanced budgets, however, actually exacerbated partisan divisions over budget policy and particularly over taxes. George H. W. Bush had been denounced by conservative Republicans for signing the 1990 tax increase, and congressional Republicans unanimously opposed the tax increase signed by Bill Clinton three years later.

When Republicans gained control of Congress in 1995, they tried to repeal these tax increases and to eliminate deficits solely through entitlement and other domestic spending cuts. Bill Clinton vetoed their initial attempt and then, as deficits quickly disappeared, blocked Republican efforts to restore the income tax policies of the Reagan years. With George W. Bush's victory in 2000, however, the Republican tax policy agenda was revived. A massive tax cut was passed in 2001, with additional tax reductions in 2002, 2003, and 2004. Spending for defense also surged during Bush's first term, with the wars in Afghanistan and Iraq, as did spending for entitlements and discretionary spending programs. This new disconnect between revenues and spending policy, amplified by an economic recession, rapidly erased the surplus that Bush had inherited and pushed the deficit to more than $400 billion by 2004.

As the economy recovered, deficits began to fall in Bush's second term, but the structural policy gap between revenues and spending remained. Bush and congressional Republicans never mounted a serious attempt to eliminate this structural deficit through domestic spending cuts, and they refused to consider a wartime tax program. Bush not only resurrected the "guns and butter" approach that Lyndon Johnson had taken during the Vietnam War but extended it to include tax cuts. For Bush and most congressional Republicans, "historical" deficit levels were an acceptable price for their low-tax program. Meanwhile, Democratic critics called for a return to the balanced budgets of the Clinton presidency but ignored the tax program that had made these balanced budgets possible. Rather than fighting to repeal the Bush tax cuts or simply allowing them to expire as scheduled in 2011, Democrats repeatedly promised to extend them for all but the wealthiest taxpayers.

The deep recession and extraordinary turmoil in financial markets that began at the end of 2008, however, abruptly transformed the nation's fiscal outlook. From fiscal years 2009 to 2012, deficits averaged more than 9 percent of GDP, while the publicly held debt in 2012 was nearly 75 percent of GDP. As the economy recovers, both parties have promised to bring deficits under control and to stabilize debt levels, but the partisan debate over deficit reduction has been intensely politicized and quite misleading. Republicans insist that tax increases will not be needed to fund the wartime defense budgets that they promise to continue or the Social Security, Medicare, and other domestic programs that their constituents demand. Democrats reassure voters that their expansive domestic agenda can be preserved through higher taxes for the very, very few. In fact, stabilizing future budgets without much higher revenue levels would require massive cuts in defense and domestic spending that neither party can be expected to support.

This budget policy deadlock might seem surprising, considering the United States has comparatively low tax burdens for individuals and businesses. Measured against GDP, federal revenues have averaged approximately 18 percent for the past half-century, while combined federal-state revenues have usually been less than 30 percent. Revenue levels in most advanced democracies have usually been higher, and in some larger economies, such as France and Germany, they have been significantly higher. Nevertheless, balancing the federal budget has been difficult for the past half-century and appears to be even more intractable today. As citizens and policymakers grapple with the fateful fiscal choices that lie ahead, an honest and informed debate about taxes and budget policy would undoubtedly be helpful. I hope that the historical and contemporary analysis presented in this book will contribute to that debate.

I am deeply grateful to colleagues and friends who have helped me with this project. I am particularly indebted to William R. Keech and Iwan Morgan, who encouraged me to extend and refine its treatment of contemporary tax policy issues. Their insights about the partisan and interest group dimension of the politics of tax policy have proved invaluable, as has their challenge to make the book more interesting and ambitious. While I wish that these qualities were more evident in the pages that follow, they likely would have been entirely absent otherwise. I would also like to acknowledge a long-standing intellectual debt to James D. Savage, whose work has encouraged me to integrate the history of budget policy into contemporary policy analysis.

Christine Carberry has brought her extraordinary meticulous standards to the preparation of this manuscript. From its earliest stage to its completion, she has truly been indispensable. Finally, Southern Methodist University provided a research leave that allowed me to work full time on this book. The university has also provided generous research support over the years. I am sincerely thankful to all.