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Debt limit stalemate forces new look at tax hike debate

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While the walkouts, finger-pointing and ideological lines in the sand are nothing new to Washington politics, the current debt-ceiling stalemate has opened a dangerous new chapter in economic and political brinkmanship.

Dueling Democrats and Republicans have squared off in past similar talks over shrinking federal budget deficits. From President Ronald Reagan vs. Democratic House Speaker Tip O'Neil to President Bill Clinton against Republican House Speaker Newt Gingrich, the head-banging ritual is a time-honored tradition.

And it hasn't always been pretty, as the government shutdowns of 1995-96 attest.

In the end, in the past, they always reached a compromise, with both sides accepting spending cuts and tax increases they didn't like.

But this time just might be different. The staggering amount of current debt and this year's deficit alone at $1.5 trillion are a new order of magnitude. Then too, pressure from tea party Republicans to raise no taxes have upped the stakes and complicated current talks.

It all makes it wholly uncertain whether a deal to raise the debt limit can be reached by Aug. 2, when the government will begin defaulting on its debt obligations, which could spawn chaos in financial markets around the world and kick the U.S. economy back into deep recession.

"The threat of having economic repercussions from not getting anything done is larger now," said Roberton Williams, senior fellow at the bipartisan Tax Policy Center. "We haven't faced the issue of default in the past. Simply not passing a budget so the government can't do anything, which is what we had in 1995 when the government shut down, is very different from 'You can't borrow any money. You can't pay off what you owe people.'"

Much of the concern focuses on higher interest rates that will come if the government defaults. But Bruce Bartlett, a former Treasury official during the Reagan and first Bush administrations, said that's a trivial problem compared to the possibility that credit markets could freeze up as they did in the early 2008 days of the Great Recession.

"And that's a realistic possibility that cannot be dismissed," Bartlett said. Republican refusal to negotiate in good faith and consider tax increases only increases the chances, he said.

"It just seems like there's no middle ground," Bartlett added. "I just don't see where the compromise comes from that allows the debt limit to increase."

While progress in negotiations has been hard to see, there's been no shortage of posturing and grandstanding by politicians hoping to seal an advantageous deal.

That's one reason why many Republicans simply don't believe Democratic claims that the government will default if the Aug. 2 deadline isn't met. (Of course, it's not just Democrats; Federal Reserve Chairman Ben Bernanke, the U.S. Chamber of Commerce, the National Association of Manufacturers, and many Wall Street leaders all issued warnings this week.)

Likewise, many Democrats think Republicans will cave on their pledge to oppose any agreement that includes any higher taxes.

Both parties' mutual distrust may have merit, said Dan Mitchell, a senior fellow and tax expert at the Cato Institute, a libertarian think tank.

"It's always a safe assumption that politicians of both parties are going to exaggerate and demagogue. That's just in the blood. It's in the genes. That's just the way they are," Mitchell said.

Not since the Omnibus Budget Reconciliation Act of 1993, when President Clinton raised taxes on high earners, increased fuel taxes and created the 35 percent top tax rate for corporations, has Republican opposition to tax hikes been so unified and unyielding.

Back in 1993, every Republican in Congress voted against the so-called deficit reduction act, claiming it would cause another recession just as the nation recovered from the 1990-91 recession. GOP rhetoric against the legislation was memorable.

Former Rep. Robert Michel of Illinois, the House GOP leader, said of the Democratic plan: "They will remember who let loose this deadly virus into our economic bloodstream."

Rep. Wally Herger of California protested that "the Clinton tax plan will spur inflation, lose jobs, increase the deficit and hurt our economic growth."

And former Ohio congressman and current Ohio governor John Kasich said he'd "have to become a Democrat' if the Clinton tax plan worked.

The GOP doom-and-gloom predictions were all wrong. The 1993 plan helped usher in the longest period of uninterrupted economic expansion in U.S. history, climaxed by four straight years of federal budget surpluses.

Williams, of the Tax Policy Center, said the incident shows that trying to attribute or predict U.S. economic performance based on one factor such as tax hikes simply doesn't work.

"There've been times when we've raised taxes and the economy has done well, and we've had times when we've raised taxes and the economy has not done so well," Williams said.

President George H. W. Bush found that out in 1990, when a recession and a bulging federal deficit forced him to violate his 1988 campaign "Read my lips, no new taxes" pledge. By signing the Omnibus Budget Reconciliation Act of 1990, Bush raised individual income tax rates, Medicare taxes and phased out personal exemptions for five years.

The economy didn't tank, but it didn't thrive, either, and the political fallout sparked a revolt among the GOP's anti-tax conservative wing. Pat Buchanan challenged Bush's renomination and helped inflame the party's division. Then business mogul Ross Perot mounted his third-party candidacy, which split Republican votes and helped elect Bill Clinton in 1992.

The elder Bush probably hoped his tax plan would receive the same grudging acceptance as

Ronald Reagan's. "The Gipper," revered by today's Republicans as a conservative icon, signed nearly a dozen tax hikes over his final seven years in office to reduce deficits after he cut taxes deeply in 1981.

Experts still dispute how much the so-called "Reagan boom" years of 1983 to 1989 - when the economy grew as unemployment and inflation dropped - were the product of the 1981 tax cuts or the subsequent tax hikes, which helped tame the deficit.

Either way, the fact that Reagan, an anti-tax movement icon, saw fit to raise taxes to reduce federal deficits offers an example that even staunch conservatives can change their stripes if the situation warrants.

"Cutting spending has the same effect on the economy as raising taxes. And if you argue that raising taxes is a bad thing from an economic perspective, you should equally argue that cutting spending will do the same thing," said Williams of the Tax Policy Center.

Today's Republicans, of course, don't see it that way. They want to cut federal spending deeply, but are aghast at tax hikes.

Bartlett said the political demise of George H.W. Bush convinced GOP leaders that tax hikes are political suicide.

"And I don't know that they're necessarily wrong," Bartlett said. "At some point the American public is going to have to shift their attitudes (about tax hikes), but the (Obama) administration has done nothing to bring them along."
