

The Budget Crisis: Is It All Déjà Vu?

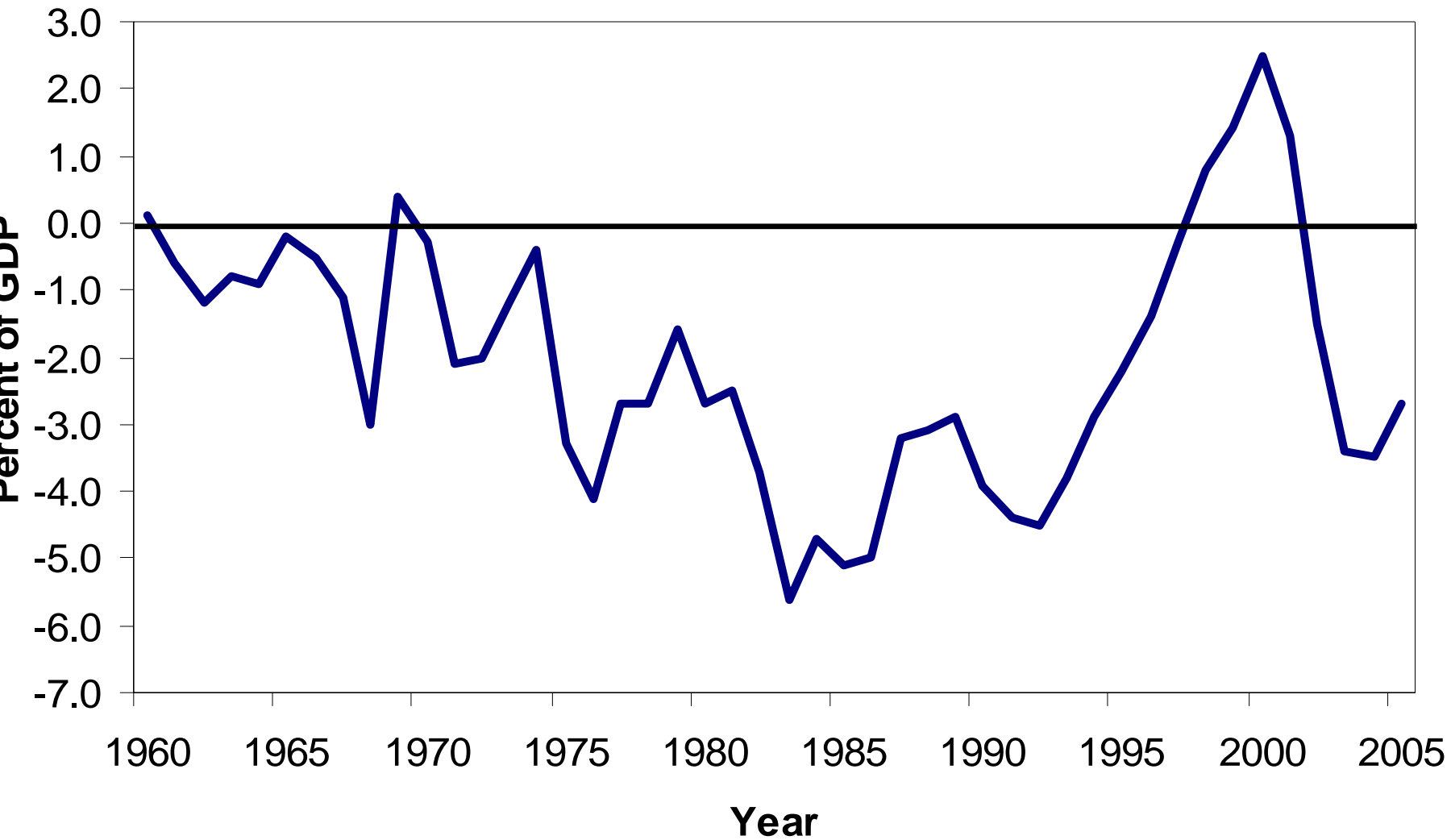
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A Quarter Century of Dramatic Change

- 1980-95
 - Large budget deficits as far as the eye can see
- 1995-2000
 - Budget surpluses as far as the eye can see
- Today
 - Budget deficits as far as the eye can see

Total Deficit or Surplus, 1960-2005



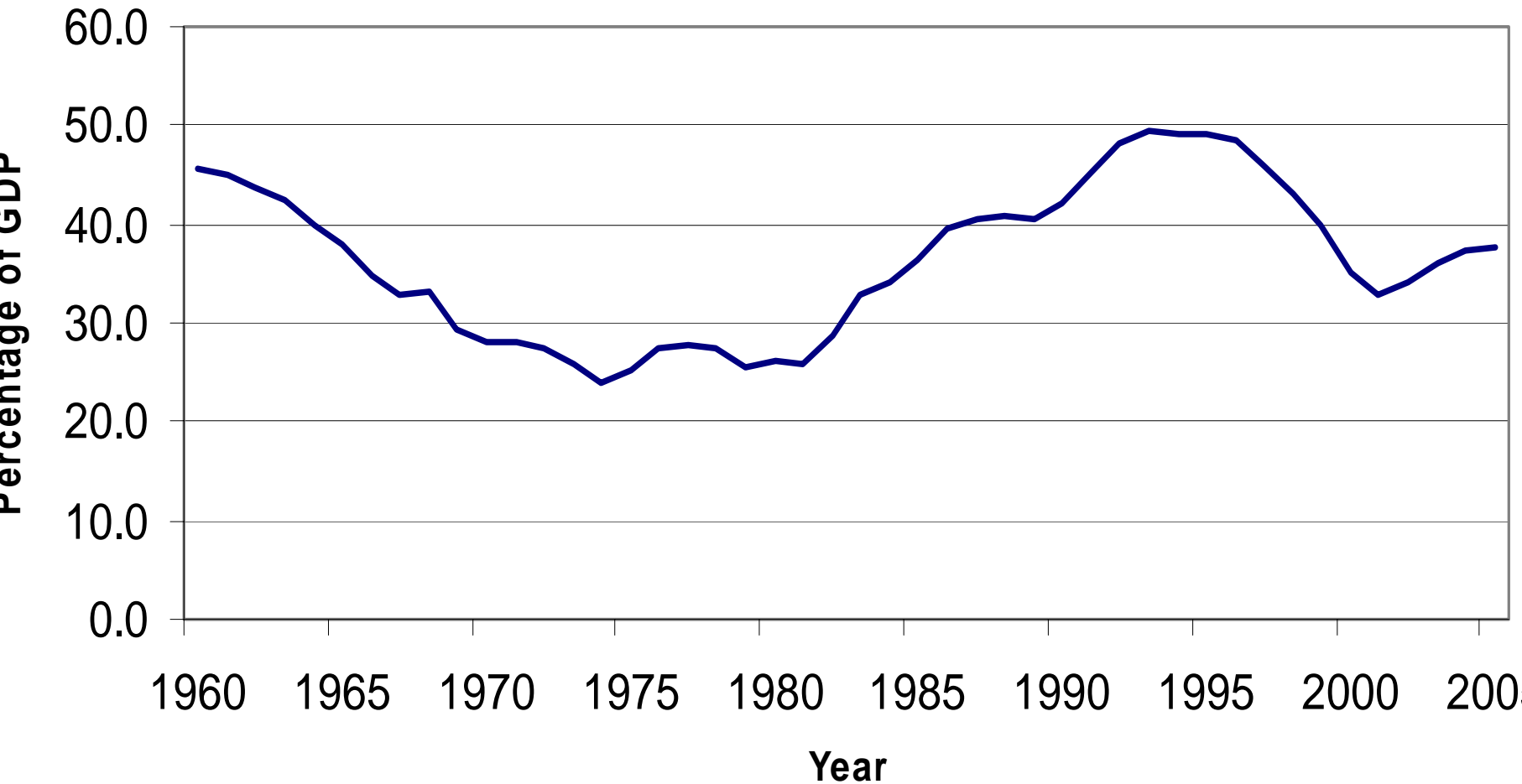
Outline of Paper

- Budget History
 - Fiscal Stalemate of the 1980s
 - Fiscal Consolidation of the mid-1990s
 - Re-emergent Deficits of 2000
- Budget Outlook
 - Near-Term
 - Population Aging and Long-Term
- Budget Reform

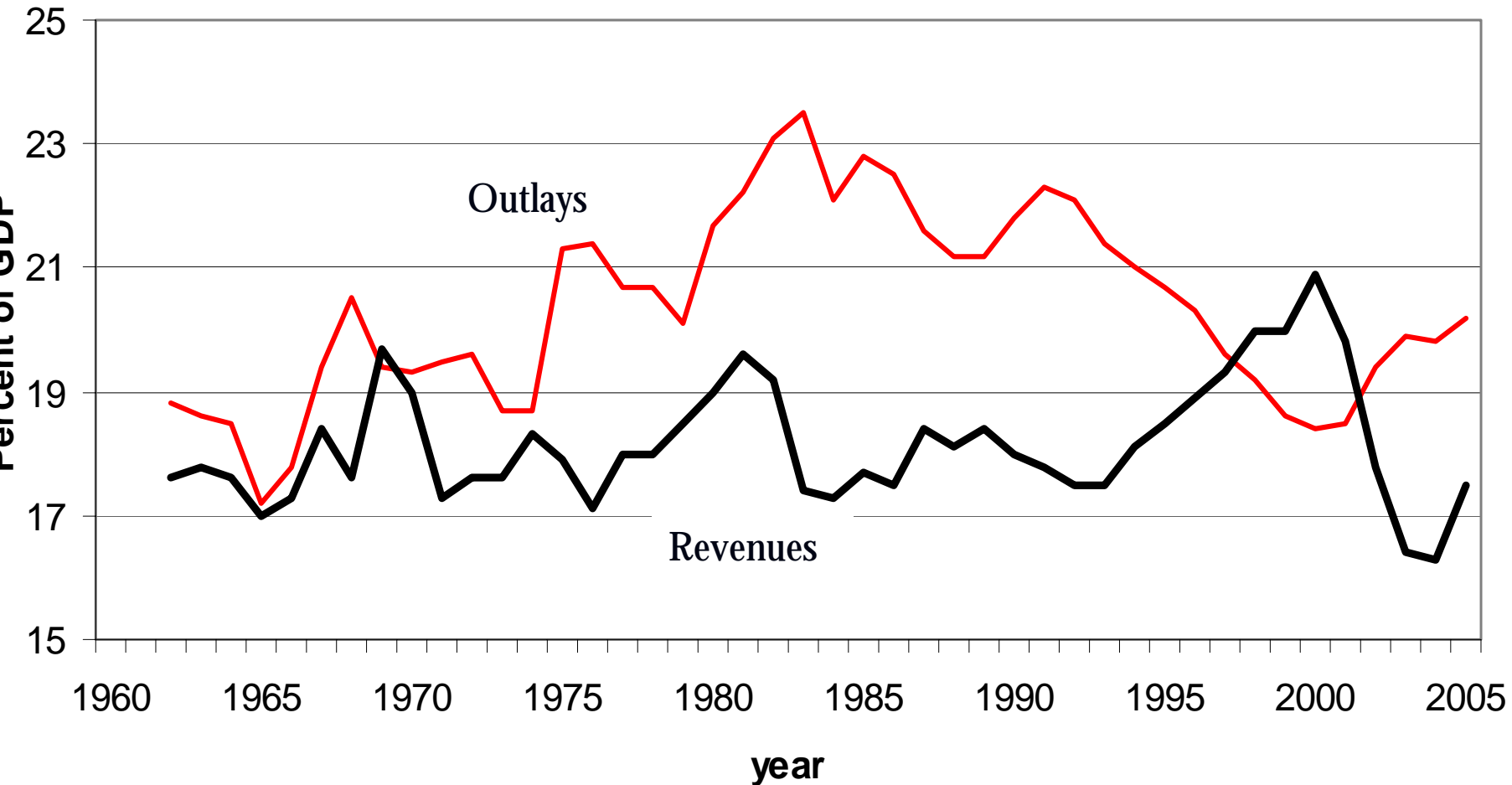
Fiscal Stalemate 1980-95

- History of small deficits
 - Declining Debt-GDP ratio
- Reagan Revolution
 - Deficit as political tool
 - Inflation-indexed tax system
- 1990 and 1993 deficit-reduction initiatives
- Uncertainty of projections

Debt Held by the Public, 1960-2005



Federal Revenues and Expenditures, 1962-2005



Tracking Budget Changes

- CBO budget projections
 - 5-year horizon
 - 10-year horizon after 1995
- Sources of revisions
 - Legislative
 - Economic
 - Macroeconomic outlook
 - GDP, personal income, and corporate profits
 - Technical
 - Changes in effective tax rate (capital gains)
 - Entitlement program costs

Revisions in the Projections of the Fiscal 1995 Budget Balance, 1990-95

Billions of dollars

Projection Year	Initial Balance	Revisions			Revised Balance
		Legislative	Economic	Technical	
1989					-110
1990	-110	160	-74	-34	-57
1991	-58	-4	-16	-116	-194
1992	-194	-3	-6	-82	-284
1993	-284	54	15	45	-171
1994	-171	-7	-2	4	-176
1995	-176	0	2	13	-161
Change 1989-1995		200	-81	-170	-51

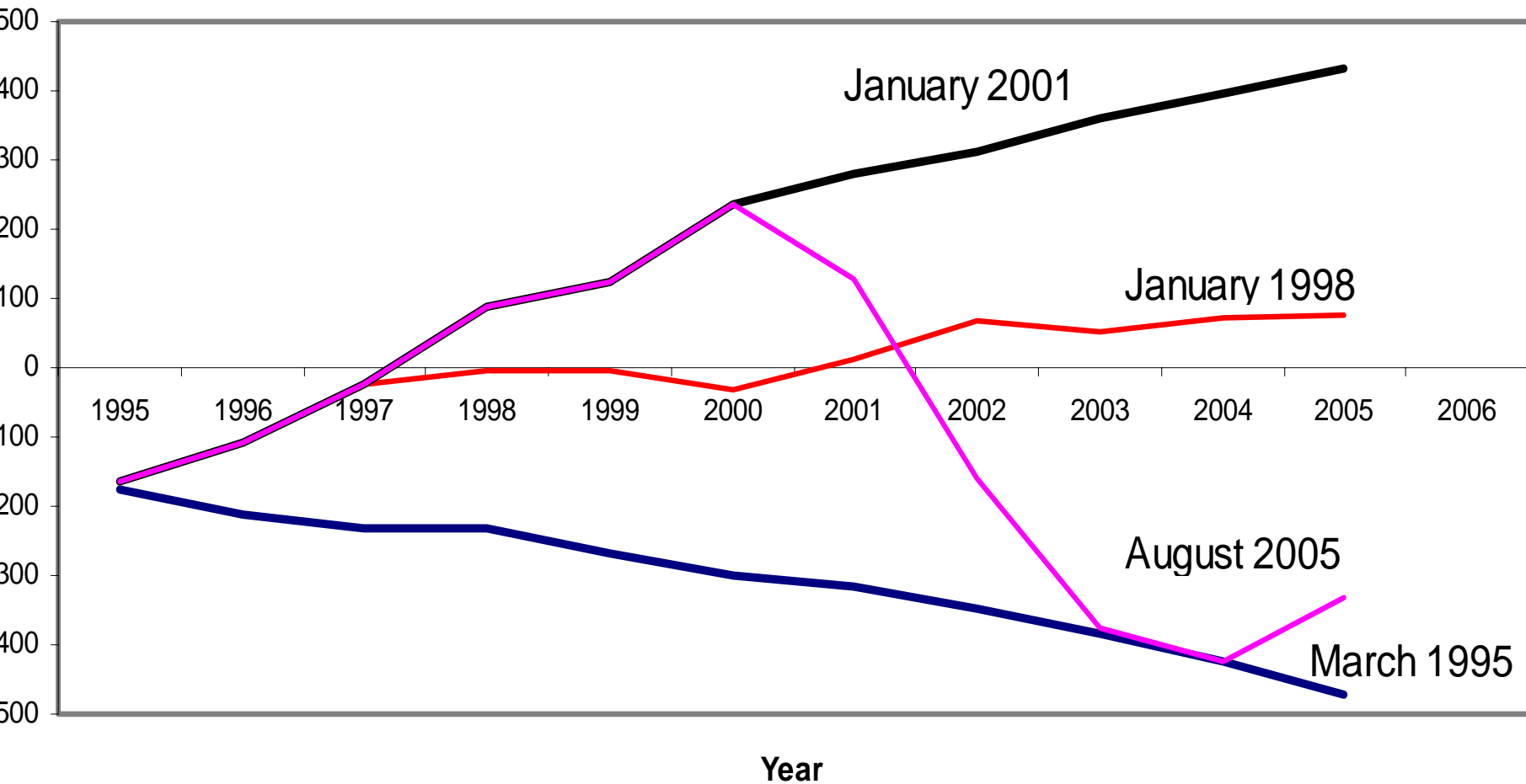
Source: Congressional Budget Office, *Budget and Economic Outlook*, various issues.

Fiscal Consolidation 1995-2000

- Luck not policy
 - Little legislative actions
 - Economic and technical revisions
 - Effects of stock market bubble
- Accelerating growth
 - Productivity resurgence (Economic)
 - High utilization (low unemployment)
 - Stock market (technical – effective tax rate)

Congressional Budget Office Projections, Unified Budget, 1995-2005

Billions of dollars



Source: Congressional Budget Office, *Budget and Economic Outlook*, various issues.

Revisions in the Budget Projections for Fiscal Year 2005, 1995-2005.

Billions of dollars

Changes in Projections:

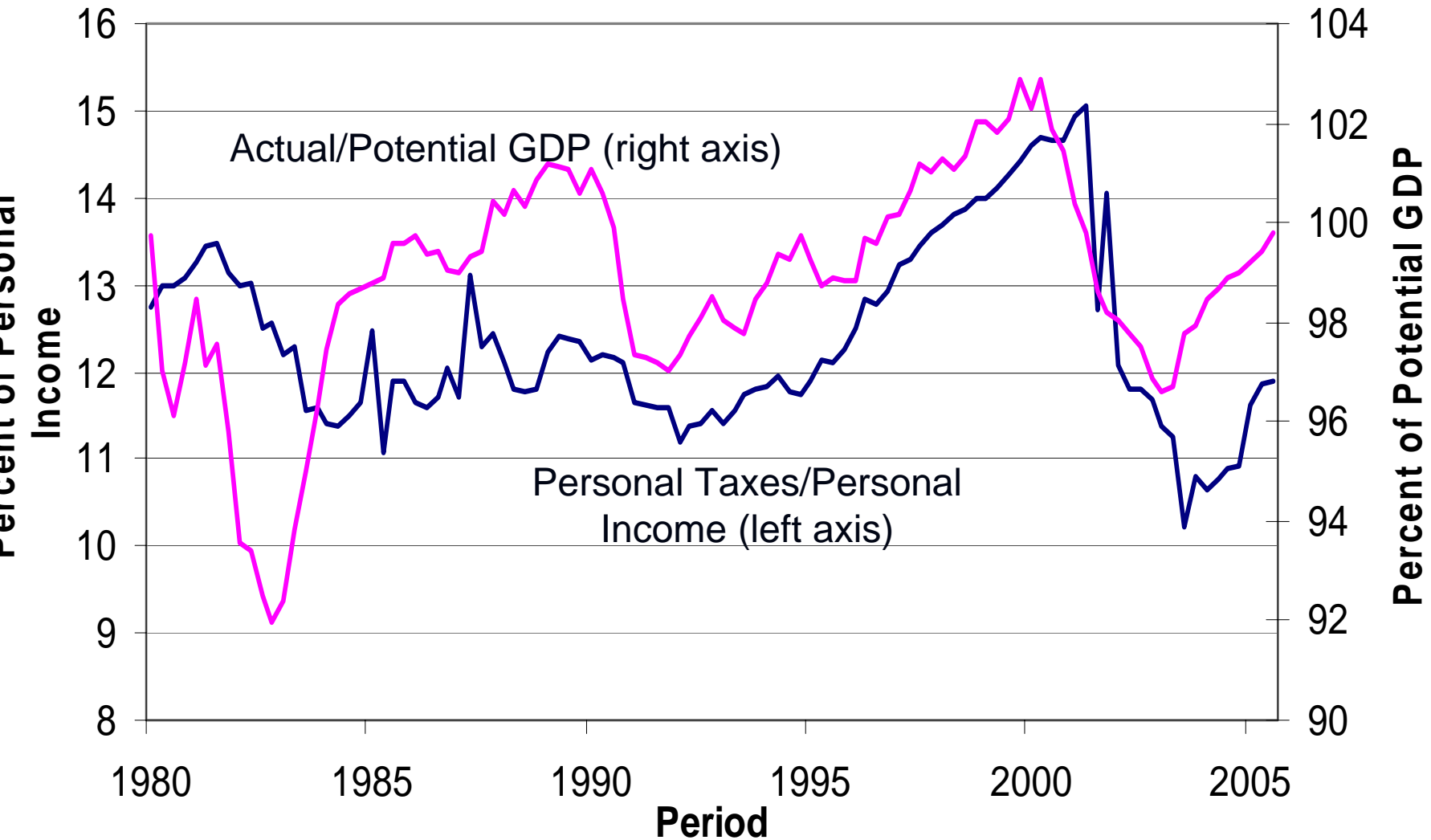
Projection Year	Initial Balance	Revisions			Revised Balance
		Legislative	Economic	Technical	
1995-2000	405	43	396	401	433
2001-2005	433	-543	-6	-213	-331

Source: Congressional Budget Office, *Budget and Economic Outlook*, various issues.

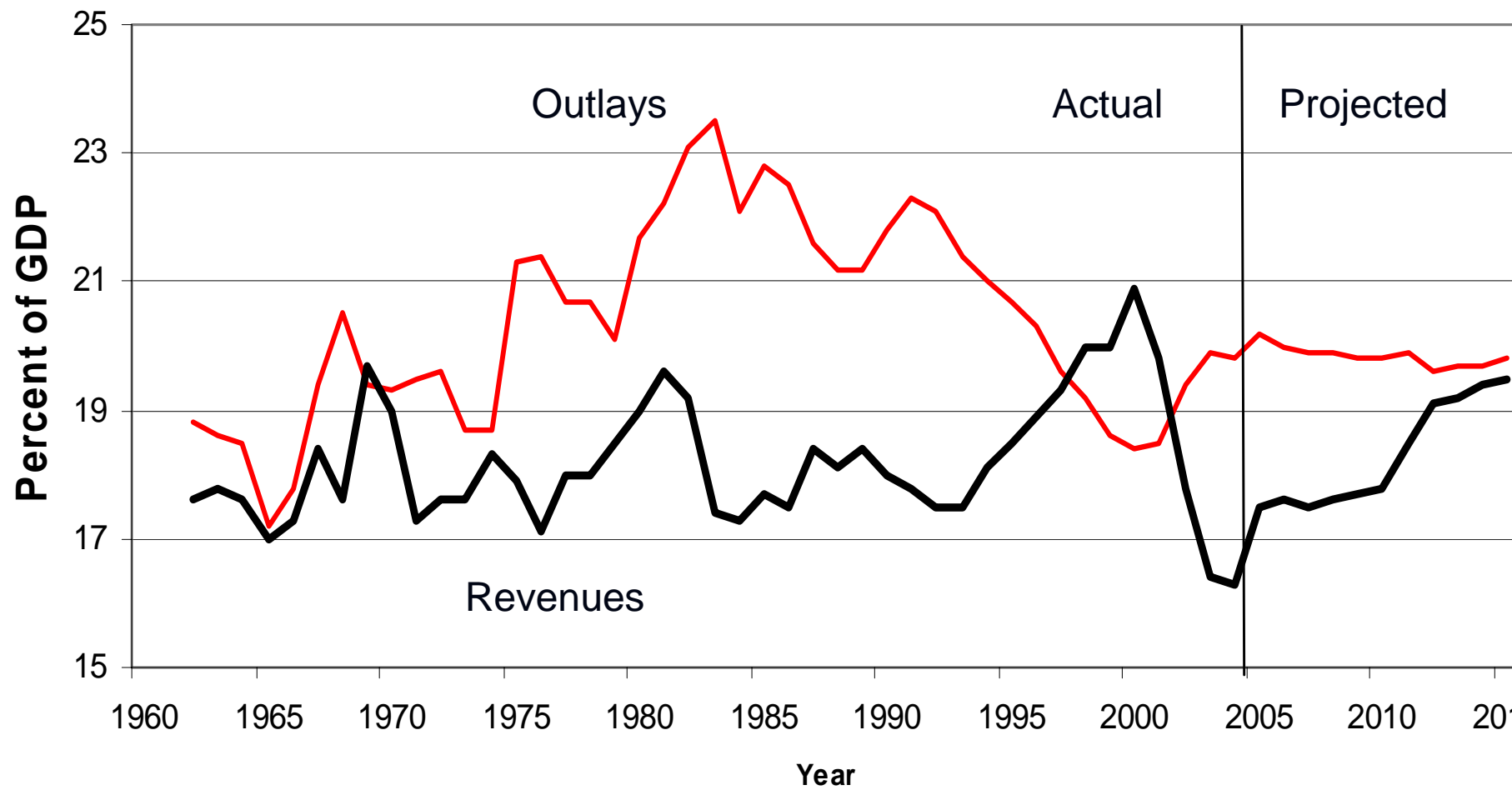
Re-emergent Deficits

- Dominated by tax reductions
 - Mistaken belief that sources of revenue increase were permanent
 - Greenspan and dangers of reducing public debt
- Stock market crash (technical revisions)
- Tax cuts as fiscal stabilization
 - Accidental but well-timed
 - Monetary policy ineffective

Personal Taxes/Personal Income and Actual/Potential GDP, 1980-2005



Federal Revenues and Expenditures, 1962-2015.



Source: Congressional Budget Office

Short-term Outlook

- Tax reductions were temporary
 - Implication of return to near budget balance after 2010
- Widespread belief that tax reductions will be extended
 - Lack of pressure to reduce deficits
 - Uncertain because of President's declining popularity

Short-term Outlook (2)

- **Alternative Minimum Tax**
 - Elimination of most deductions and personal exemptions
 - Not indexed for inflation
 - Effects upper middle-income
 - Very costly to fix if tax reductions extended
- Outlook is dominated by decision over extension of tax reductions

Long term Outlook

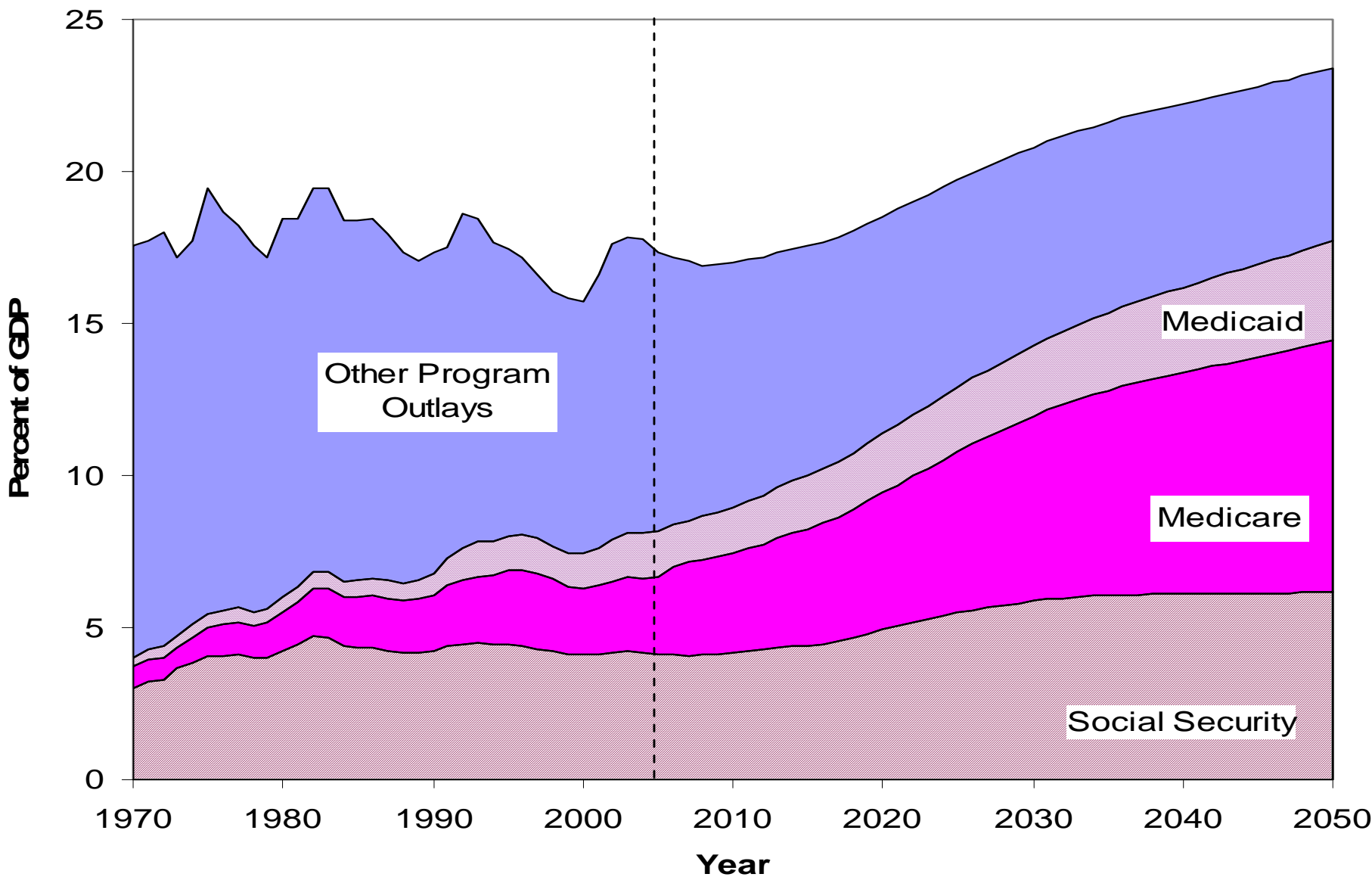
- Rising costs of entitlement programs due to population aging
- Common problem for all industrial countries
 - U.S. problems are less than most
 - Public pension is a minor problem
 - Medical Care is a large problem
 - Public programs for elderly
 - General medical cost increases

The CBO Budget Baseline and Potential Adjustments, 2004-2015.

Budget Adjustment	2005	2010	2015
BO Unified Budget Baseline, August 2005 as percent of nominal GDP	-331 -2.7	-317 -2.0	-57 -0.3
Adjustment for Expiring Tax prov. (excl. AMT)	0	-52	-431
Adjustment for Alternative Minimum Tax (includes interaction)	0	-67	-139
Discretionary spending adjustments	0	-9	-126
Unified Budget adjusted for tax provisions and discretionary spending as percent of nominal GDP	-331 -2.7	-445 -2.8	-753 -3.8

Source: CBO (2005b), table 1-6, and author's calculations

Projected Federal Program Outlays, 1970-2050.



Reforming the Budget Process

■ Procedural Changes

■ Gramm-Rudman-Hollings (GRH)

- Targeted deficit
- Easy to avoid

■ Budget Enforcement Act (BEA)

- Discretionary spending caps
- PAYGO provisions for taxes and entitlement changes
- Effectiveness is debatable.

■ Japan's system of periodic review

Reforming the Budget Process(2)

■ Accrual Accounting

- Include future costs of current commitments
- Major effect is on pension-type programs
- Present value of future benefits less present value of future contributions
- Infinite horizon - open class
- Unfunded liabilities of pension is negative for future participants – old debt
- Unfunded liabilities of Medicare are large for all cohorts – future debt

The Present Value of Unfunded Liabilities, Social Security, Infinite Horizon

	Trillion \$	Percent of GDP
Social Security (OASDI)		
Future costs less benefits - current participants	13.7	1.5
Less: Current trust fund	1.7	0.2
Equals: Unfunded obligations, current and past participants	12.0	1.3
Future costs less benefits - future participants	-0.9	-0.1
Equals: total unfunded obligations	11.1	1.2

Source: OASDI Trustees Report, 2005 table IV.B7 and the HI and SMI Trustee's report, tables III.B11, C5, and C21.

The Present Value of Unfunded Liabilities, Medicare, Infinite Horizon

	Trillion \$	Percent of GDP
Medicare		
Future costs less benefits - current participants	26.0	2.7
Less: current trust fund	0.3	0.0
Equals: Unfunded obligations, current and past participants	26.3	2.7
Future costs less benefits - future participants	42.3	4.4
Equals: total unfunded obligations	68.6	7.1
of which: Part A	24.3	2.5
of which: Part B	25.8	2.7
of which: Part D	18.2	1.9

Source: OASDI Trustees Report, 2005 table IV.B7 and the HI and SMI Trustee's report, tables III.B11, C5, and C21.

Conclusion

- Little pressure to resolve budget issues
- Projections are very uncertain
- Short-run budget outlook is largely determined by extension of tax cuts
- Long-run outlook is dependent on reform of medical care system.
 - Cannot continue system of un-rationed health care for elderly