The Budget Crisis: Is It All Déjà Vu?

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The Brookings Institution
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

Source: Congressional Budget Office
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

Source: Congressional Budget Office
Federal Revenues and Expenditures, 1962-2005

Source: Congressional Budget Office
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**

<table>
<thead>
<tr>
<th>Projection Year</th>
<th>Initial Balance</th>
<th>Revisions Legislative</th>
<th>Economic</th>
<th>Technical</th>
<th>Revised Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>-110</td>
<td></td>
<td></td>
<td></td>
<td>-110</td>
</tr>
<tr>
<td>1990</td>
<td>-110</td>
<td>160</td>
<td>-74</td>
<td>-34</td>
<td>-57</td>
</tr>
<tr>
<td>1991</td>
<td>-58</td>
<td>-4</td>
<td>-16</td>
<td>-116</td>
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</tr>
<tr>
<td>1992</td>
<td>-194</td>
<td>-3</td>
<td>-6</td>
<td>-82</td>
<td>-284</td>
</tr>
<tr>
<td>1993</td>
<td>-284</td>
<td>54</td>
<td>15</td>
<td>45</td>
<td>-171</td>
</tr>
<tr>
<td>1994</td>
<td>-171</td>
<td>-7</td>
<td>-2</td>
<td>4</td>
<td>-176</td>
</tr>
<tr>
<td>1995</td>
<td>-176</td>
<td>0</td>
<td>2</td>
<td>13</td>
<td>-161</td>
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</table>

**Change 1989-1995**

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>200</td>
<td>-81</td>
<td>-170</td>
<td>-51</td>
<td></td>
</tr>
</tbody>
</table>

*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.

billions of dollars

<table>
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<th>Projection Year</th>
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<th>Economic</th>
<th>Technical</th>
<th>Revised Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995-2000</td>
<td>405</td>
<td>43</td>
<td>396</td>
<td>401</td>
<td>433</td>
</tr>
<tr>
<td>2001-2005</td>
<td>433</td>
<td>-543</td>
<td>-6</td>
<td>-213</td>
<td>-331</td>
</tr>
</tbody>
</table>

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

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

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

Source: Congressional Budget Office
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

<table>
<thead>
<tr>
<th></th>
<th>Trillion $</th>
<th>Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Social Security (OASDI)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Future costs less benefits - current participants</td>
<td>13.7</td>
<td>1.5</td>
</tr>
<tr>
<td>less: Current trust fund</td>
<td>1.7</td>
<td>0.2</td>
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<tr>
<td>equals: Unfunded obligations, current and past participants</td>
<td>12.0</td>
<td>1.3</td>
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<tr>
<td>Future costs less benefits - future participants</td>
<td>-0.9</td>
<td>-0.1</td>
</tr>
<tr>
<td>Equals: total unfunded obligations</td>
<td>11.1</td>
<td>1.2</td>
</tr>
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</table>

### The Present Value of Unfunded Liabilities, Medicare, Infinite Horizon

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<thead>
<tr>
<th>Description</th>
<th>Trillion $</th>
<th>Percent of GDP</th>
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<tr>
<td><strong>Medicare</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Future costs less benefits - current participants</td>
<td>26.0</td>
<td>2.7</td>
</tr>
<tr>
<td>less: current trust fund</td>
<td>0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>equals: Unfunded obligations, current and past participants</td>
<td>26.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Future costs less benefits - future participants</td>
<td>42.3</td>
<td>4.4</td>
</tr>
<tr>
<td>Equals: total unfunded obligations</td>
<td>68.6</td>
<td>7.1</td>
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<tr>
<td>of which: Part A</td>
<td>24.3</td>
<td>2.5</td>
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<tr>
<td>of which: Part B</td>
<td>25.8</td>
<td>2.7</td>
</tr>
<tr>
<td>of which: Part D</td>
<td>18.2</td>
<td>1.9</td>
</tr>
</tbody>
</table>

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