

The Budget Crisis: Is It All Déjà Vu?

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The Budget Crisis: Is It All Déjà Vu?

by
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Large and sustained budget deficits have re-emerged as a central focus of the debate over U.S. economic policy. For those with memories of the acrimonious budget conflicts of the 1980s, this is discouraging news. Members of the two political parties spent over a decade blaming the other for the deficits, while essentially doing nothing. However, the optimists among us can counter with the reminder that the logjam was ultimately broken in the 1990s, and the U.S. actually enjoyed substantial budget surpluses by the end of the decade. Is it possible that history will simply repeat itself, and a return to the budget discipline of the 1990s will again restore balance?

The parallels between today's situation and that of the 1980s are striking in several dimensions. David Stockman, Ronald Reagan's first budget director, is alleged to have referred to a future of "\$200 billion budget deficits as far as the eye can see."² In 2004, a Washington study group resurrected the Stockman quote in projecting budget deficits of \$300 billion per year, again "as far as the eye can see."³ It might seem as though little has changed.

However, it is important to remember that the intervening years witnessed a dramatic reversal. Stockman's structure deficits were transformed into surpluses. By 1998 the United States had its first budget surplus in 30 years, and the subsequent three years saw substantial surpluses, even within the more narrowly-defined non-Social Security budget. Several Clinton Administration officials went so far as to speak of "budget surpluses as far as the eye can see."⁴ By 2001, the Congressional Budget Office (CBO) was projecting surpluses that averaged in excess of \$500 billion annually over the following decade.

¹ I am indebted to Lisa Bell for her research assistance and suggestions from Charlie Schultze.

² Although widely attributed to Stockman by others, the specific context is not documented.

³ Center on Budget and Policy Priorities and others, 2004.

⁴ Gene Sperling, Director of the National Economic Council, as quoted in "After Deficits, Expectations of Surplus," *Washington Post*, February 1, 1998; and Jacob Lew, Director of the Office of Management and the Budget, in testimony before the House Committee on Ways and Means, February 23, 1999.

But now, the surpluses have disappeared and we are back to projections of significant deficits in future years. The variations in those projections are also substantial. The CBO bases its projections on current law, under which the tax cuts of 2001-2003 are assumed to expire, revenues are a substantially increasing share of GDP, and expenditures are limited by strict spending caps. The objective is not to produce a forecast, but to provide the Congress with a baseline from which to evaluate its future budget actions. As a result, the CBO shows a shrinking deficit that falls to less than one percent of GDP by the end of the 10-year projection period. However, alternatives that incorporate policy proposals of the President and congressional leaders imply deficits equal to about 3 percent of GDP. Given the enormous volatility of past projections of budget outcomes, and the wide range of today's alternatives, it is not clear how seriously we should view the current set of projections.

The central theme of this paper is that the comfort of history is not a good guide to the future. First, the political process has received too much credit for an extraordinary set of fortuitous events that brought about fiscal balance in the 1990s. Those or similar events are unlikely to reoccur in the future. Second, in contrast to the options for expenditure savings occasioned by the end of the Cold War in the 1990s, the U.S. is faced with growing future fiscal pressures that come largely from the costs of supporting a growing population of retired persons. Bringing the future budget into balance is likely to be more difficult.

However, at present and for some time into the future, the United States faces little or no pressure to change its ways. The global economy with its insufficiency of aggregate demand imposes a very soft budget constraint. The United States is still under no pressure to finance its debts in foreign currencies, the risk of crisis is largely born by others, and the debt continues to be financed at low and even declining interest rates. Absent external pressures political leaders will persist in the belief that budget deficits don't matter.

The following section provides a brief history of the efforts since 1981 to resolve the conflict over how to reduce the budget deficit, the events that led to the emergence of the budget surplus in the late 1990s, and events of recent years, which saw a return to large and sustained budget deficits. The fiscal outlook is examined in the second section of the paper. The final section addresses some of the proposals for the reforming the budget process.

Shifting Views of Budget Deficits

The election of Ronald Reagan in 1980 represented an epochal shift in the conduct of U.S. budget policy. Prior to the 1980s, the Democrats were the unvarying advocates of new expenditure programs, and the Republicans played the institutional role of stingy naysayers, arguing for fiscal prudence and a concern for budget deficits. This all changed in 1980, as the Republicans under Reagan became the cheerful gift givers, asserting that Americans deserved tax cuts. Democrats were forced onto the defensive of objecting that the country could not afford the tax reductions, and adopting the prior Republican position that deficits were bad. The period also marked the rise of supply-side economics, but the underlying and more significant change was a political one in which budget deficits have come to be viewed as a weapon that can be used to prevent the introduction of new programs and to force a scaling back of the old.

It is true that budget deficits were the normal state of affairs even in the years before Reagan, with only one year of surplus since 1960. However, the deficits were typically minor – particularly after adjustment for business-cycle fluctuations – and the growth of the public debt was far less than that of GDP, declining from 46 percent of GDP in 1960 to only 26 percent in 1980 (Figure 1). Despite being a minority in the Congress, Republicans were generally successful in limiting the growth of government, and both expenditures and revenues fluctuated in a narrow band about 20 percent of GDP. There was however, a substantial shift in composition as the share devoted to defense declined and funds were redirected into programs for retirees.

After 1980, the budget deficits were large and persistent, and the growth of the public debt outpaced the nation's income, reaching a peak of 49 percent of GDP in 1995. While the focus has centered on the Reagan tax cuts, the deficits were as much the product of expansions of the expenditure programs as a decline in the effective tax rate (figure 2). Beginning with the pre-recession year of 1979, expenditures rose from 20.1 percent of GDP to a peak of 22.8 percent in 1985 and the share was still two percentage points above the 1979 level in 1992 (22.1). Expenditures rose relative to GDP both because of a defense buildup aimed at putting greater pressure on the Soviet Union, and a sharp rise in real interest rates that accompanied an equally momentous change in U.S. monetary policy, as the Federal Reserve initiated a vigorous anti-

inflation program. Meanwhile, the decline in revenues as a share of GDP was from 18.5 percent in 1979 to 17.3 in 1984 and 17.5 in 1992.⁵

Since 1981, CBO has published budget projections for five years into the future and provided a detailed explanation for its revisions, distinguishing between legislative changes, changes due to revised estimates of the macroeconomic outlook, and a residual category of other technical factors.⁶ Beginning in 1995 the projection period was extended out to 10 years. The data provides a rich history that allows us to examine the sources of change in the budget outlook in some detail.⁷ In using this data set, it is useful to distinguish between the years before 1995 when the budget deficit proved to be stubbornly persistent and the years after 1995.

Fiscal Stalemate. The first half of the 1980s was dominated by the Reagan budget initiatives and a very severe recession. In later years, despite an outpouring of economic studies stressing the costs of budget deficits and a series of Congressional actions to bring them under controls, little progress was made. Figure 3 uses the CBO data to compare the actual budget deficits with the projections of the CBO five years earlier.⁸ The actual and projected deficits are shown in the top panel. As expected, the largest discrepancy is the comparison of the actual balance for 1986, a large deficit, with the equally large surplus projected back in 1981, prior to the enactment of the Reagan program. However, the 1981 budget projections were highly unrealistic in relying on inflation to push taxpayers into higher tax brackets.⁹ After 1986, there is surprisingly little correlation between the projected and actual budget outcomes. A substantial projected improvement was not realized when a projected improvement was wiped out by the 1991 recession.

⁵ Inflation and a recession did push the effective tax rate to a peak of 19.6 percent of GDP in 1981, the first year of the Reagan Administration.

⁶ The distinction between economic and technical revisions is somewhat arbitrary. In CBO's analysis, differences that can be directly linked to macroeconomic variables of the national accounts are labeled economic. Other differences, even those that might be tied to economic performance, such as changes to estimates of capital gains realizations or labor force participation, are categorized as technical.

⁷ A detailed analysis of the CBO revenue projections is provided by Auerbach (2000).

⁸ It is possible to compare the actual and projected values of the deficit for each year of the 5-year projection horizon. However, the differences show a high degree of autocorrelation.

⁹ At the beginning of the 1980s, the income tax was not adjusted for inflation, which pushed taxpayers into higher marginal tax brackets. Because of its reliance on current law, the CBO incorporated the 'bracket creep' into its projections. The 1981 tax act introduced indexation of the tax brackets and the personal exemption beginning in 1985.

In the lower panel the discrepancy between the actual and original projected budget balance is allocated among legislative changes in taxes and the entitlement, changes in discretionary spending relative to the baseline, and a residual category of unforeseen changes in the economic outlook and technical factors. The Congress did act to scale back the initial tax cuts and reduce entitlement spending, but savings in those areas were largely offsetting by increases in entitlement spending above the baseline. Over the period as whole, the economic and technical changes accounted for the dominant portion of the differences between prior plans and outcomes.

The failure to make progress in reducing the budget deficit was particularly disappointing because of two major efforts to enact legislation aimed at bringing the deficits under control. In November 1990, the Congress enacted and President Bush signed the Omnibus Budget Reconciliation Act (OBRA90) that included a tax increase, caps on discretionary spending and changes in some entitlement programs. In August 1993, President Clinton signed the Omnibus Budget Reconciliation Act of 1993 (OBRA93), with a similar mix of tax increases and spending restraints.

The effects of those two acts on the budget deficit can be shown by tracking the evolution of the CBO projections for the FY 1995 budget beginning in March of 1990. The analysis is based on the same CBO data set discussed previously, but the focus is on how the projections for a specific year change over time. The changes are shown in table 1. The first column shows the FY1995 budget deficit as projected at the beginning of each year. The next three columns show the CBO revisions throughout the year, allocated among those that were due to legislative actions, those due to changes in the economic outlook, and technical revisions in the estimates. The last column shows the revised budget baseline of the following year. OBRA90 called for reductions in the 1995 budget deficit of \$160 billion, of which about \$40 billion were in tax increases. However, large portions of the projected gains were quickly wiped out by the costs of the 1991 recession and technical re-estimates. By January of 1993, the projected budget deficit (\$284 billion) was larger than the estimate prior to OBRA90 (\$110 billion). OBRA93 was more successful in that it was not offset by subsequent changes in the economic and technical factors. The policy changes were smaller – largely because they are measured only two years beyond the enactment – but they were bolstered by favorable economic and technical revisions, and the deficit was significantly reduced. Still, the actual budget deficit

for 1995 was larger than what was being projected prior to the two deficit reduction programs. The experience highlights the extreme uncertainties surrounding budget projections.

Fiscal Consolidation. In March of 1995, the CBO was still anticipating ‘large and growing deficits as far as the eye could see.’ Figure 5 shows the ten-year projections, extending out to 2005, with an anticipated budget deficit of \$472 billion. Yet, by 1998 the deficit had disappeared and the projections had changed to promises of growing surpluses as far as the eye could see.¹⁰ By 2001, the CBO was projecting a FY2005 surplus of \$433 billion – a revision from the estimate of 5 years earlier of \$900 billion, or more than 7 percent of GDP. To put the revision in perspective, it exceeds the projected share of GDP projected to cover the federal costs of population aging over the next 50 years.

What happened? Did the politicians suddenly change and undertake policy actions to close the budgetary gap? That is the explanation often put forth in public discussions that credit adherence to strict budget discipline during the 1990s. However, it appears that the revisions were largely the result of unforeseen changes in the economic situation and technical factors, and not the result of policy change. Again the CBO data can be used to track the revision in the budget outlook, but the analysis can be extended out to ten years to capture a larger portion of the long-term effects of the legislative actions. The annual revisions in the budget outlook for FY2005 are shown in table 2. The presentation is the same as in table 1. The first column shows the 2005 budget deficit as projected at the beginning of each year. The next three columns report the CBO revisions during the year, and the last column shows the revised budget baseline at the beginning of the following year.

The cumulative effects of those revised estimates for the FY2005 budget are shown at the bottom of the table. The most notable feature is the trivial role played by the legislative changes between 1995 and 2000. Of a total change in the projected budget balance of \$838 billion (from a \$405 billion deficit to \$433 billion surplus), only \$43 billion is recorded as the result of legislative actions. More was done in 1996-97 when the discretionary actions reduced the projected deficit by about \$130 billion, but some of the restraint was offset in the run-up to the 2000 election.

¹⁰ The CBO highlighted this reversal of fortunes with a graph on the cover of its July 2000 budget update that showed the change in the baseline projections between 1997 and 2000.

Instead, most of the improvement can be traced to changes in the economic and technical factors, with each contributing about \$400 billion between December of 1995 and January of 2001. The economic factors were an unexpected surge of productivity growth after 1995 and a benign inflation outlook that allowed the achievement of an extraordinarily low unemployment rate. Faster income growth and lower inflation both made major contributions to the improved budget outlook. The technical revisions incorporated the large income and capital gains taxes associated with the run-up of equity prices, and the resulting popularity of options and bonuses which contributed to a windfall of tax receipts. In addition, a shift in the distribution of income toward the individuals at the top of the distribution was an added factor that contributed to an increase in the effective tax rate.¹¹ Finally, the last half of the 1990s was a period of unexpectedly low medical care cost inflation. In effect, the budget benefited from an extraordinary run of good luck, not policy change.

It can be argued that the CBO baseline is too rigorous a standard against which to measure Congressional actions on discretionary spending, since adjustments are made only for general inflation. Thus, what is shown in figure 2 as a substantial decline in discretionary spending as a share of GDP actually exceeded the 1995-96 baselines. If the baseline for discretionary spending was assumed to be a constant share of GNP, the Congress would have been credited with an additional \$60 billion in spending reductions by 2000; but that is still relatively small compared to the magnitude of economic and technical revisions. Furthermore, the reductions in the share of GDP devoted to discretionary spending during the 1990s were heavily concentrated in defense, and can be traced directly to the end of the Cold War. Between 1990 and 2000, defense spending fell from 5.2 to 3.1 percent of GDP, while non-defense discretionary programs declined by 0.2 percent of GDP to 3.3 percent. Cuts in defense spending were used to finance above baseline spending in non-defense programs and still remain below the overall budget targets (table 3).

Re-emergent Deficits. The emergence of large budget surpluses in the late 1990s was a surprise; but their potential transitory aspects were also well understood by the staff of the CBO and other budget experts. In its annual outlook, the CBO devotes a chapter to the analysis of past discrepancies between actual and projected outcomes; and in 2001 CBO introduced a new

¹¹ For details see Kasten and others (1998) and Weiner (2004).

probability-based analysis designed to emphasize the wide range of potential future outcomes. CBO staff members (Kasten and others, 1998) published an analysis highlighting the importance of the stock market in generating the revenue surprise, even if CBO could not project a stock market crash. Altig (2000) reviewed the factors that contributed to the budget surplus and emphasized their transient nature.¹²

Kliesen and Thorton (2001) published a timely analysis that highlighted the uncertainties, and showed that the past 5-year surplus/deficit projections of CBO had proved to be uncorrelated with ultimate outcomes. Their chart is updated with the more recent budget results in figure 6. However, the comparison is subject to conflicting interpretations. Consistent with their emphasis on the uncertainties behind the projections, there is no positive correlation between the projected and actual budget balances. However, it is also possible to observe a suggestion of a negative relationship. That could result if the Congress actually does believe the projections and reacts to them. For example, the projected surpluses of recent years surely contributed to the pressures for legislated tax reductions. It is harder to make such a case that the projected deficits for the late 1990s led to legislative action. As shown in table 4, the negative correlation in those years was more the result of large economic and technical changes.

Despite the cautions, both political parties made plans to utilize the projected surpluses. The Republican Congress proposed a round of tax reductions in 1999, and the Clinton Administration favored a combination of tax reductions and expenditure increases. President Bush called for a major tax reduction in the 2000 election. The tax cut also gained significant momentum from the support Alan Greenspan, who in early 2001 expressed his concerns that continued budget deficits would lead to the elimination of the public debt and consequent purchases of private sector claims by the government markets (Greenspan, 2001). Greenspan attributed the surpluses to higher productivity growth, which he argued would continue, ignoring the more transitory factors from equity markets. President Bush also viewed the underlying budget trends as sustainable in arguing “We can proceed with tax relief without fear of budget deficits, even if the economy softens.”¹³

¹² In a related article that argued against a general tax reduction, Auerbach and Gale (2000) outlined a wide range of other potential claims on the budget, such as higher discretionary spending, reforming the Alternative Minimum Tax, and removing the retirement accounts and their current surpluses from the budget calculations. However, they placed less emphasis on the transient nature of the surpluses.

¹³ Speech at Western Michigan University, March 27, 2001.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTTRA) was enacted in June of 2001. Although the annual budget cost averaged only about \$150 billion over the next ten years, it began a process by which the projected FY2005 budget balance was converted from a \$430 billion surplus to a \$40 billion deficit in less than 18 months. Congress passed the Job Creation and Worker Assistance Act (JCWTA) in 2002 and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) in 2003, both of which accelerated and expanded the 2001 tax reduction. As shown in table 2, the direct (economic) effects of the 2001 recession were relatively small (\$81 billion); but the collapse of the bubble in high-tech equities had large negative impacts that are captured in the technical revisions to the outlook. The dominant role of legislative actions and the stock market decline are shown in the summary measure of the change in the budget projection over the 2000-2005 period—a change in the budget outlook for a single year of over \$700 billion.

Although both President Bush and Alan Greenspan oppose the use of fiscal policy for stabilization purposes, the 2001 fiscal actions could be defended as one of the best-timed fiscal actions in recent memory.¹⁴ The U.S. economy peaked in March of 2001, and EGTRRA was signed into law in June. Although the recession is characterized as mild, an important reason was that the tax reductions provided significant support to consumer spending. Monetary policy also responded quickly -- the target federal funds rate was cut 13 times from a peak of 6½ percent in early 2002; but the actions appeared ineffective outside of some support for residential construction, and short-term interest rates were near zero by mid-2003. An indicator of cyclical conditions, the ratio of actual to potential GDP is shown in the top panel of figure 5. While the recession was less severe than the deep recession of 1981-82, it has been surprisingly sustained. Also, the second panel indicates the magnitude of the collapse in business investment which is much more severe than in 1981-82, and for which the recovery is very incomplete. Most striking is the speed and magnitude of the decline in the effective personal income tax rate, shown in the bottom panel. It reflects both the tax reductions and the drop in tax liabilities due to the fall in

¹⁴ The use of fiscal policy for stabilization purposes fell into some disfavor among economic policy makers during the 1980s and 1990s (Greenspan, 2001), primarily as a reflection of a belief that monetary policy would be more effective and timely. However, there has been some resurgence of interest more recently as concerns emerged about the efficacy of monetary policy when interest rates approached a zero limit. Articles by Auerbach (2005) and Blinder (2004) reach more positive conclusions about the usefulness of fiscal policy.

equity markets (technical changes). It is a much larger reduction in the effective income tax rate than occurred in 1981-83.

The Outlook for Fiscal Policy

The debate over future fiscal policies is often confusing because it revolves around two largely separate issues. First, in the near term, many observers fear a replay of the 1980s in which the large tax reductions and defense spending of the Reagan Administration plunged the United States into a long and acrimonious debate over the policies to eliminate a large budget deficit (Auerbach and others, 2003). Second, the United States faced a longer-term budget problem, echoing that of other countries, of how to pay for the retirement needs of an aging population. While the two concerns are related, the first arises largely on the revenue side, as how to restore financing for a level of government activity that is at or below historical norms. The second involves the expenditure side of the budget and a debate over how to respond to a greatly expanded claim on the nation's future resources.

The Near-term Outlook. The speed with which the budget balance shifted from large deficits to large surpluses over a span of only a few years is mind-boggling, and it is common to see in that a return to an era of large and sustained deficits.¹⁵ Yet, the CBO projections, presented in figures 1 and 2, show a steady shrinkage of the deficit to less than one percent of GDP at the end of the projection period. The discrepancies arise largely out of differences in the assumptions of what should constitute a baseline for evaluating future policy options.

The CBO continues its past policy of basing its projections on current law, and projects future reductions in the deficit because most of the earlier tax reductions are scheduled to expire over the next ten years. In addition, CBO is required to use a baseline for non-defense spending that limits future increases to inflation adjustments. In contrast, the budget pessimists argue that the CBO assumptions are increasingly unrealistic in failing to include some legislative adjustments that they believe are inevitable from a political perspective.

The magnitude of the differences in budget projections is outlined in table 4. Using the August 2005 CBO estimates, the budget deficit would decline from 2.7 percent of GDP in 2005

¹⁵ Examples are provided by Auerbach and others (2003) and the Center on Budget and Policy Priorities and others (2004).

to less than one percent by 2012. However, if, as proposed by President Bush, the tax reductions of 2001-2003 are extended, the deficit would remain at current levels as a share of GDP. If the Congress also decides to cut back the Alternative Minimum Tax (AMT), the deficit would rise to about 3 percent of GDP. Additionally, an assumption of growth in discretionary spending more in line with historical experience would push the deficit up over time to about 4 percent of GDP. These adjustments do suggest the return to a budget situation similar to that of the late 1980s. However, they are also based on a projection of tax and expenditure plans that depart substantially from current law.

A number of political leaders have already called for extension of the 2001-2003 tax reductions beyond their scheduled expiration at the end of the decade. However, the inclusion of changes in the AMT originates from different sources. The AMT was originally designed to impose taxes on high-income individuals who were able to use various provisions of the existing law to eliminate any tax liability. The AMT required them to recalculate their tax liability under rules that severely limited their use of deductions, exemptions and other tax preferences. They pay the higher of the two liabilities. The significance of the AMT is limited largely to the one-thirds of taxpayers who itemize their deductions. For others, they apply two tax rates of 26 and 28 percent to income above an excluded level. The income exclusion implies that taxpayers with income below \$50,000 are unaffected, and a maximum tax rate of 28 percent limits the applicability of the alternative tax to persons with income in excess of \$500,000. However, the exclusion is not adjusted for inflation, so that the AMT covers an increasing number of taxpayers over time. In addition, the exclusion is phased out for taxpayers with incomes over \$150,000, raising effective marginal rates. By 2010, about 20 percent of taxpayers, and 90 percent of those with income between \$100,000 and \$500,000, will owe taxes under the AMT.

The AMT differs from the regular income tax primarily in eliminating personal exemption (one per family member) and excluding itemized deductions other than mortgage interest. While it greatly increases the complexity of the tax system, complexity may not matter in an era in which most taxpayers and tax preparers rely on computer programs to do the calculations. As a model of an alternative stand-alone tax system, the AMT has some appeal in eliminating a plethora of tax deductions, but its interaction with a parallel system creates significant distortions and inequities. The change outlined in table 4 calls only for indexation of the basic AMT system; outright repeal would cost considerably more, about \$150 billion in 2010

and rising rapidly thereafter. However, if the income tax reductions are not extended, the added cost of eliminating the AMT would fall to \$50 billion annually.

In summary, the United States faces some major budgetary decisions over the next few years. It is important to remember, however, that decisions that are projected to lead to large and sustained budget deficits have not yet been made. If the Congress treats the tax measures as temporary, as currently scheduled, the fiscal outlook over the next decade is quite favorable. In contrast to other industrial countries, the United States has scaled back government spending by large amounts relative to GDP, and is well-positioned to deal with the coming cost of an aging population. On the other hand, the decision with respect to future tax policy may have greater economic consequences for the U.S. economy than in the 1980s. In the 1980s, much of the budget deficit could be offset by a private saving rate of about ten percent of GDP; but, since 2000, the private saving has averaged less than five percent of GDP, putting substantially greater pressure on the U.S. external account. In the mid-1980s, the current account deficit peaked at about three percent of GDP; today, it is in excess of 6 percent.

Population Aging and the Long-term Budget Projections. All of the major industrial countries face fiscal challenges of varying magnitude as a result of the aging of their populations. In this dimension, the U.S. is in the group of countries with a more favorable fiscal outlook. The aging of the U.S. population will occur well after that of Japan and most of Europe, and it is less substantial. Because the U.S. birth rate has remained near replacement levels, it is faced with an aging, but not outright decline of its population. Second, the U.S. operates a public pension program that is less costly and relies more on alternative sources of income for the elderly than most other countries.

Medical care is the one area in which the fiscal problems of the United States exceed those of other countries. In all countries, medical care costs rise as individuals age: The average annual medical costs of persons over 65 are about 5 times those of those under age 65. That is a significant added fiscal cost in countries with some form of national health insurance. However, the United States has national health insurance only for the aged and a limited program for the poor. Others receive health care through a private system. As result, the public sector costs of health care increases about twelve-fold after age 65 (Aaron and Bosworth, 1996).

The dominant role of medical care is evident in the long-term budget projections of the CBO shown in figure 7. The projections are based on current law with respect to program eligibility and assume that cost per enrollee grow one percent faster than per capita GDP. This assumption implies major efficiency gains relative to the historical record. In addition, the costs of a new prescription drug program for the elderly are not included in the projections. Over the next 50 years, program outlays are projected to rise by eight percent of GDP with only two percentage points from the pension program and a projected decline of 2 percentage points in the non-retirement programs. The medical care programs rise by 8 percent of GDP. These projections suggest that the share of GDP devoted to government spending will rise by roughly 50 percent over the next half century. Tax increases of this magnitude appear completely unreasonable to most observers and account for the claims that U.S. fiscal policy is on an unsustainable path (Greenspan, 2005).

Reforming the Budget Process

The notion of budget surpluses ‘as far as the eye could see’ disappeared with remarkable speed after 2000. While a portion of the loss can be attributed to the recession and the associated stock market decline, the vast bulk of the change was due to legislative actions. As shown in table 2, over two-thirds of the revision to the budget projections for FY2005 resulted from actions of the Congress, reducing taxes or increasing spending above baseline levels. Even today, Administration and Congressional leaders continue to call for the renewal of the prior tax reductions despite projections of ever-growing budget deficits. Frustration with the inability of the Congress to practice fiscal discipline has led to a resurgence of interest in various reforms to the budget process – a discussion that was particularly active during the 1980s.

Procedural changes. Some observers perceived the inability of the Congress to resolve the budget conflicts as a procedural problem and sought to change the rules by budget decisions were made. The Congress made two major attempts to control the deficits through changes in the budget process. The first of these, the Balanced Budget and Emergency Deficit Control Act of 1985, was known as the Gramm-Rudman-Hollings (GRH) Act. The act distinguished between discretionary spending programs that are subject to annual appropriations and mandatory programs, where the Congress establishes basic eligibility and other program rules,

but does not determine spending through annual appropriations. GRH set annual deficit targets and called for the sequestration of discretionary spending if those targets were not achieved. Mandatory spending programs, which represented over half of the budget, were exempt from the sequestration process.

Even with some modifications in 1987, GRH never worked. A primary problem was that the deficit targets applied to planned levels of taxes and expenditures. Thus, the Congress and the administration could avoid the constraints by adopting optimistic economic and technical assumptions to project deficits that complied with the targets. The deficit targets were achieved in the budget resolutions, but never in practice. There was also an increased reliance on one-time actions, such as accelerating tax payments or selling government assets, which brought the budget into line with annual target, but never altered the underlying trend.¹⁶

The Budget Enforcement Act (BEA) replaced GRH in 1990. With revisions, it continued to provide a basis of budget decisions until 2002, when it was allowed to lapse. It also divided the budget into two parts: (1) caps on discretionary spending to be enforced by sequestration, and (2) pay-as-you-go (PAYGO) rules for changes in taxes and mandated spending (basically the entitlement programs). The PAYGO provision prevented legislation that would lower taxes, create new entitlement programs, or expand existing programs unless the costs were offset by other legislative action. It provided a strong mandate in support of the status quo.

The effectiveness of the BEA remains subject to considerable debate. Certainly, during the period that it was in force, there was a large and dramatic decline in the budget deficit; however, it is not evident how much credit should be given to the BEA procedures. After all, the focus of the BEA was legislative actions, not the deficit; and as noted by Auerbach (2000) and discussed above, legislative actions appear to have accounted for a very small portion of the decline in the deficit. The Congress often adjusted the discretionary spending caps; and, as shown by Irving (2002), the award adjustment ultimately became ridiculously large. On the other hand, there is a notable absence of new programs or tax reductions, restraint which might be traced to the PAYGO provisions.

In summary, the general approach of the BEA of focusing on goals that the Congress can control, such as expenditure appropriations and tax legislation, is seen as more effective than targeting the budget deficit (GRH), which is subject to a multitude of unforeseen events. The

¹⁶ Reischauer (1990).

danger is that numerical limits often generate a large number of congressional subterfuges to camouflage the implications of their actions. The result is a loss of transparency in the presentation of the budget and budget process. Even the PAYGO procedures, which garner more approval, create a presumption in favor of the status quo and may inhibit reform measures.

In recent years, some observers have called for re-enactment of the BEA. However, as long as both the legislative and executive branches are firmly in control of a single political party, the leadership will not favor measures that limit their freedom of action. Suggestions have been made to impose caps on expenditures that would then trigger spending reductions according to some pre-agreed formula (Penner and Steuerle, 2005). Such proposals are rarely neutral, however, in their willingness to consider the option of tax changes, and are attractive only to those who favor expenditure cuts as the solution to deficit problems.

Accrual Accounting. Some analysts argue that the current budget reporting system misleads legislators and the public by failing to adequately highlight the future costs of current programs. For example, by participating in social security, workers accrue rights to future pension payments. The current cash-flow budget reflects the payments made by current workers, but does not reflect the accrual of pension rights for future years. These costs can and are presented in projections such as those reported in figure 7 that show the projections of annual costs out as far as 50 or 75 years. But it can be useful to reduce that long stream of budget values to a single number that reflects the extent of financial imbalance. Those discounted present-value calculations are now reported annually by the Social Security Administration for both Social Security and Medicare. The calculations can be made for a finite number of years into the future, but may again be misleading by including the contributions made by an age cohort, but not fully incorporating the later benefit payments. Most of the advocates of accrual accounting favor an infinite horizon, and that is the basis for the estimates reported in table 5. In addition, the estimation can distinguish between past, current, and future participants in computing the net benefit or loss.

The table includes the actuarial estimates for Social Security (retirement and disability), and the three components of Medicare: Part A (hospital), Part B (physician) and Part D (prescription drugs). Because such calculations always produce large values, it is best to focus on the percent of the parallel estimate of GDP. The tables highlight several points. First, the

funding problem of Medicare is far bigger than that of Social Security. The unfunded liabilities of Social Security amount to 1.2 percent of GDP compared to 7 percent for Medicare.

Second, the debt of Social Security is largely old debt or what might be called sunk costs. It originates from a decision to pay the first few age-cohorts a full pension benefit even though they did not pay into the program over a full work life. The money has been spent, but rather than recognize it as explicit debt, those benefits were financed out of the contributions of future cohorts of workers. Furthermore, the present value of the benefit costs of future participants less their contributions is negative, indicating that they will more than cover the costs of their benefits. Thus, the debate over Social Security financing is largely a debate over who will pay the taxes to retire the old debt; or will the debt simply be carried forward within the Social Security system.¹⁷

In contrast, the unfunded liabilities of the Medicare programs are primarily the result of future not past operations. It is a relatively young program, for which the unfunded costs arise in the future. In fact, for the drug benefit program which is just starting up, all of the estimated costs have yet to be incurred. Because it can be changed by future decisions, the unfunded liability of Medicare reflects a more meaningful economic issue than that of Social Security.

Third, it is interesting to note that the unfunded liability of the new prescription drug program (\$18 trillion) exceeds that of Social Security (\$11 trillion), whereas it is the latter that receives all of the attention in the policy debate. The fact that Congress could create such a costly and under-funded program in the midst of an ongoing discussion of the current budget deficits suggests that legislators and the public may have trouble understanding the current budget accounts. But it is notable that financial markets also paid no attention to the creation of a program that should add substantial pressure on the budget in future years.

Accrual accounting and the construction of present value measures of future fiscal obligations provide an additional perspective on future budget trends. While they clarify some of the issues, their complexity suggests that they are not likely to substitute for the existing cash accounts. The perspectives of figure 7 and table 5, are very similar: the United States faces a severe long-term budget imbalance that is concentrated in the public medical care programs for the elderly.

¹⁷ President Clinton once proposed a transfer from the federal funds portion of the budget, which was at the time in surplus, to the Social Security fund. By replacing some of the contributions of current workers which had been spent on past benefits, he was suggesting that general revenues be used to pay off some of the previously-accrued debt.

Conclusion

The perception of the late 1990s that the United States had finally resolved a long-drawn-out debate over how to respond to sustained budget deficits and rising indebtedness has proved to have been an illusion. In part the surpluses have been spent on tax reductions and the war in Iraq, but there was also insufficient appreciation of the transient nature of many of the factors that contributed to the surge of revenues in the late 1990s. It was not just capital gains. The boom in the stock market and the growth of the IT industries affected executive bonuses and stock options, pushing a larger portion of taxable income into the highest tax brackets. Much of it went away in 2001-2003, but with recovery some of these factors may come back into play.

The United States faces significant fiscal challenges over the medium (the next decade) and longer-term (subsequent decades). However, from an economic perspective, the issues are quite simple. The medium-term outlook revolves around a single dominant question: Will the EGTRRA tax reductions be extended into the next decade? If they are extended, the U.S will have significant budget deficits in future years; and by pushing taxpayers over onto the AMT with its greater inequities, the extension will create added pressures to enact a second round of reductions. Over the longer term, the issue is largely one of finding away to bring the costs of the Medicare program under control. In the other dimensions of the budgetary challenges that surround population aging, the United States is in a strong position relative to other industrial countries. It begins from a base of a relatively small government sector, and the aging of the population will occur more slowly than in other countries.

The immediate budget debate is largely a renewal of the prior and long-standing conflict over the appropriate size of government. Advocates of lower taxes perceive that the creation of a budget deficit has limited economic costs and that it is an effective means of restraining pressures for new or expanded programs. Because the government is currently under the control of a single political party, it is unlikely to adopt any of the procedural changes that are designed to force legislative actions to deal with budget deficits. At the same time, the United States faces very little external pressure to resolve the issue. The deficits have proved very easy to finance in global markets at very attractive interest rates. In both the economic and the political context the current budget situation is not perceived to be a crisis.

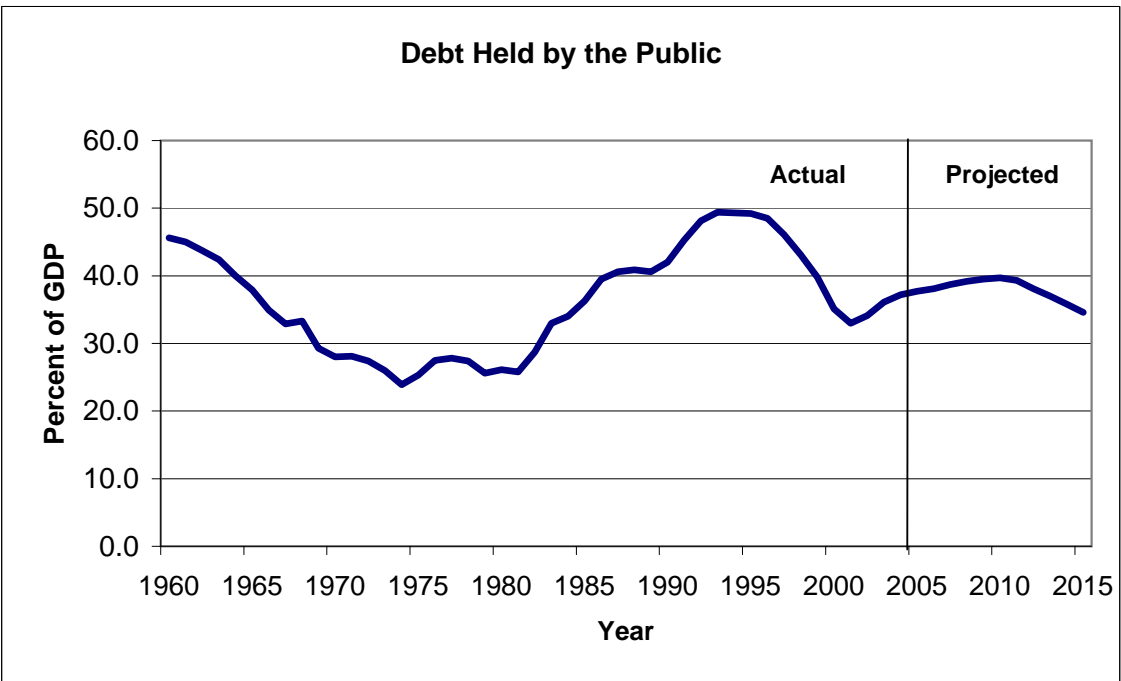
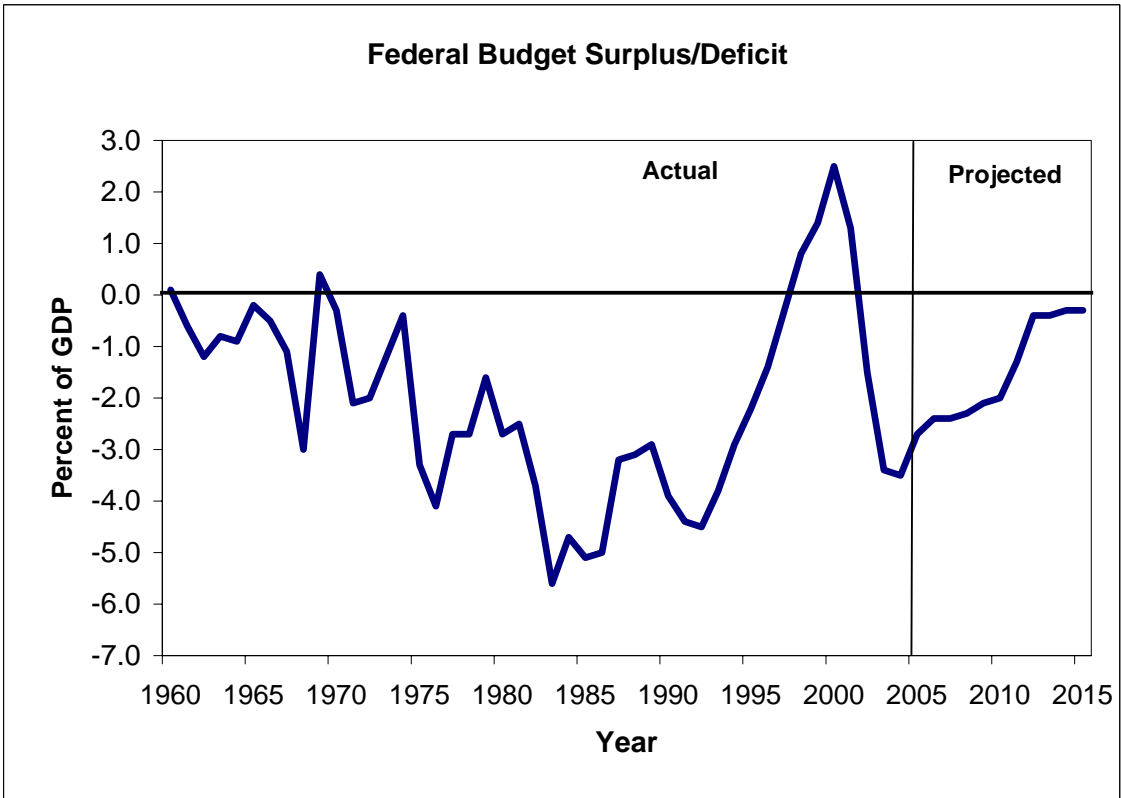
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Figure 1. The Federal Budget Balance and the Public Debt, 1960-2015.

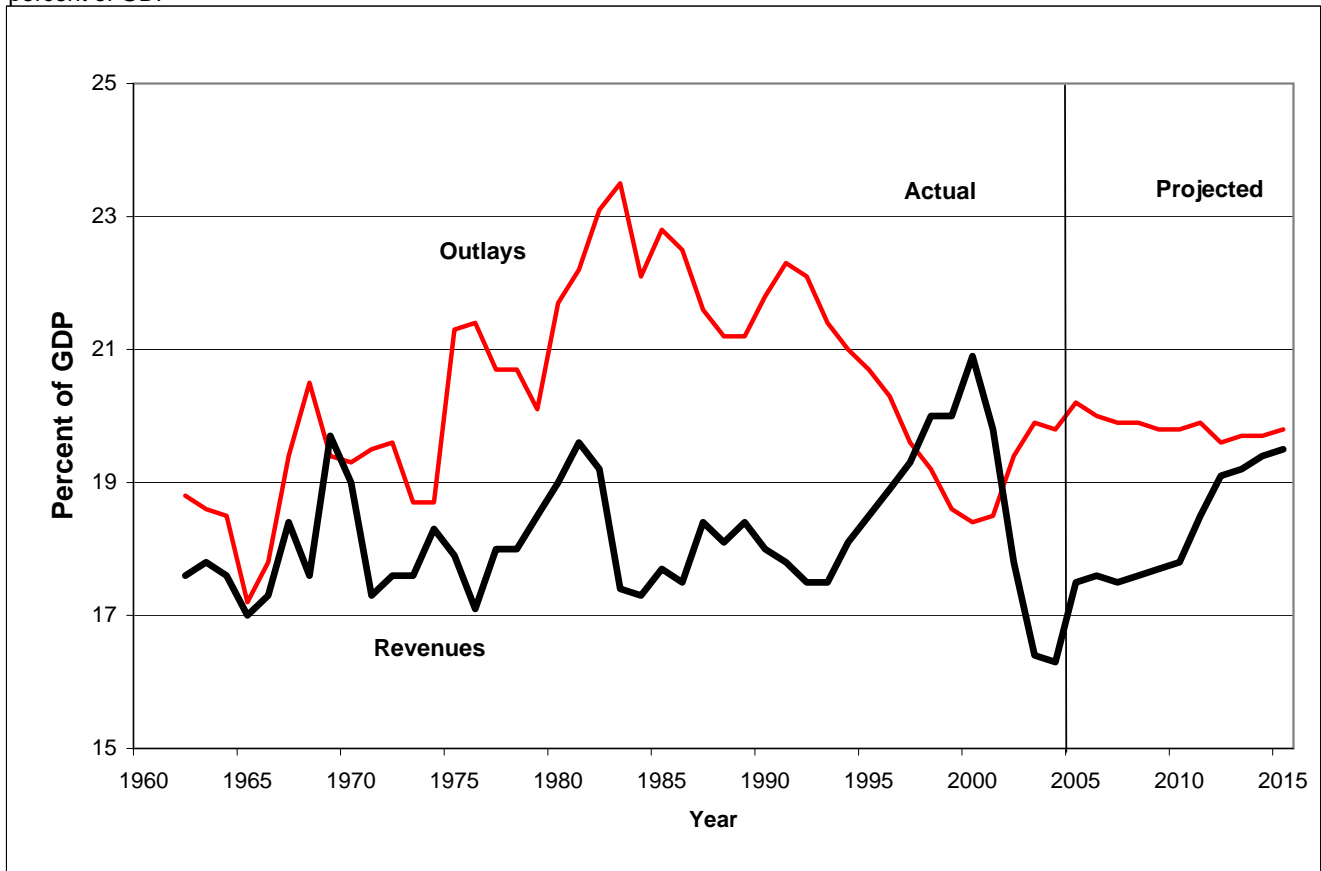
percent of GDP



Source: Congressional Budget Office (2005c).

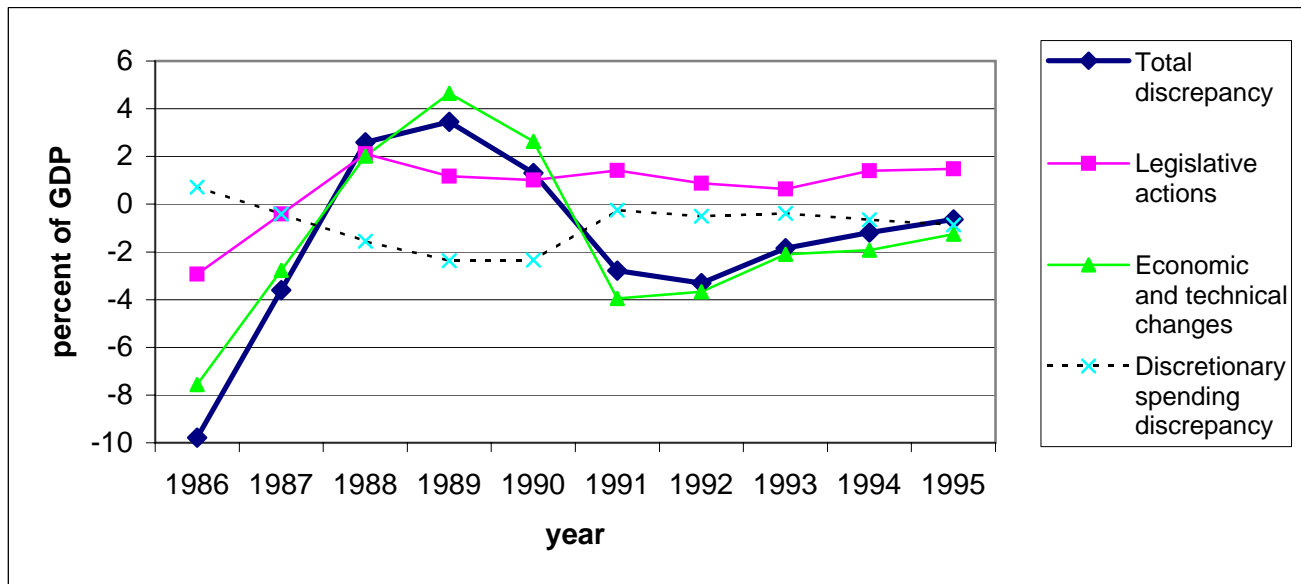
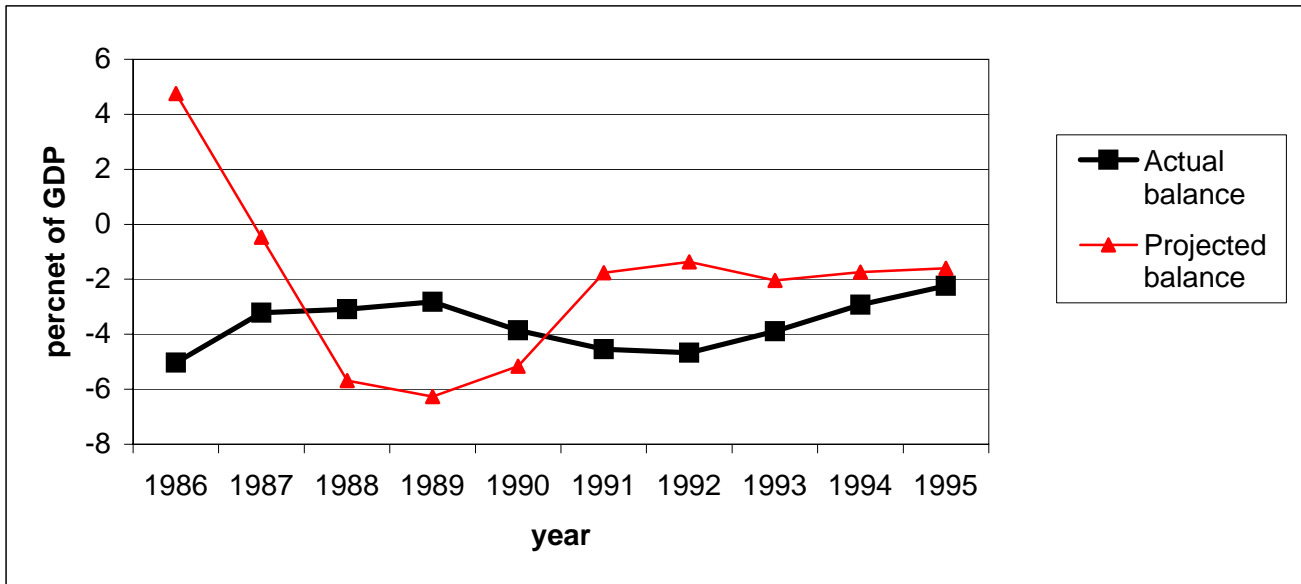
Figure 2. Federal Revenue and Expenditures, 1962-2015

percent of GDP



Source: Congressional Budget Office. 2005c.

Figure 3 The Actual and Projected Budget Balance, 1986-1995



Source: Congressional Budget Office (2005b)

Table 1. Revisions in the Projections of the Fiscal 1995 Budget Balance, 1990-95

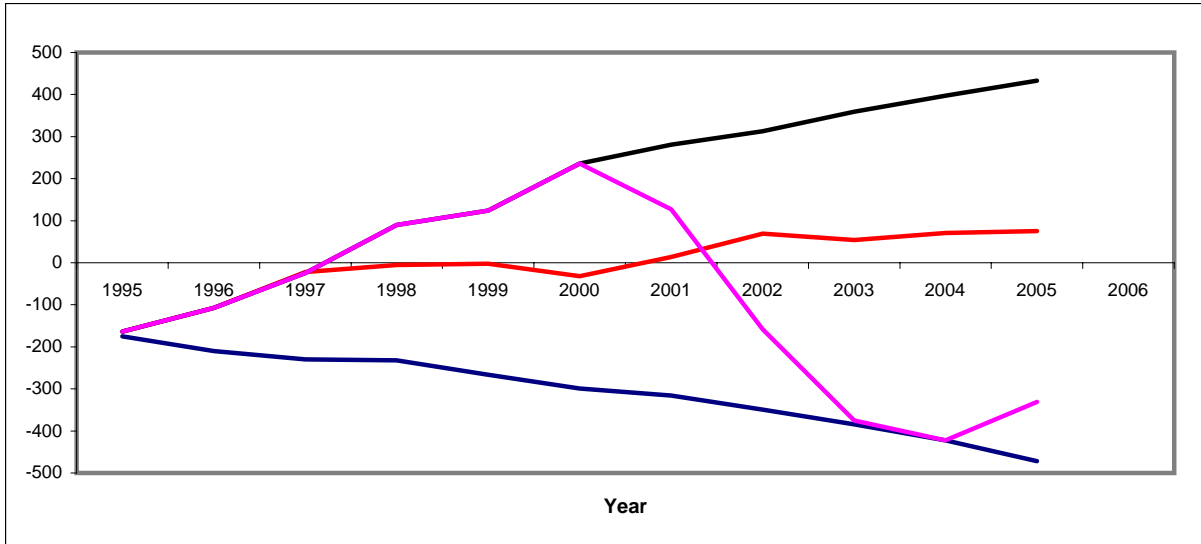
Billions of dollars

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.

Figure 4. Congressional Budget Office Projections, Unified Budget, 1995-2005

billions of dollars



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

Table 2. Revisions in the Budget Projections for Fiscal Year 2005. 1995-2005

billions of dollars

Projection Year	Initial Balance	Revisions			Revised Balance
		Legislative	Economic	Technical	
1995					-405
1996	-405	28	39	84	-254
1997	-255	95	151	85	75
1998	75	-3	65	120	256
1999	256	-11	86	47	376
2000	379	-66	55	65	433
2001	433	-197	-81	-51	103
2002	103	-64	2	-114	-73
2003	-73	-219	35	-104	-362
2004	-362	-29	13	11	-368
2005	-368	-34	25	45	-331
Changes:					
1995-2000		43	396	401	838
2001-2005		-543	-6	-213	-764

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

a. The 1995 starting value is the December baseline plus \$111 billion associated with the shift to current policy economic assumptions reported in the May 1996 Outlook.

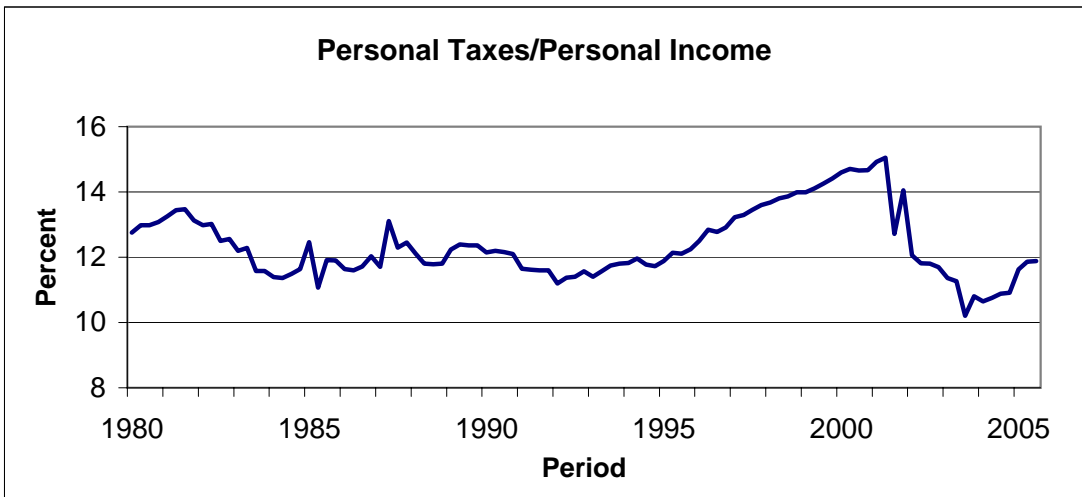
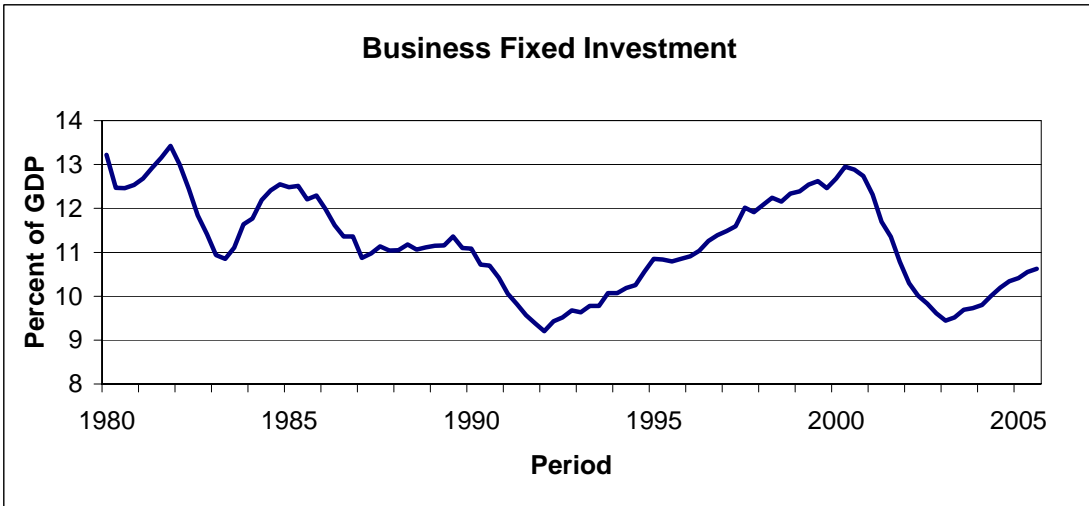
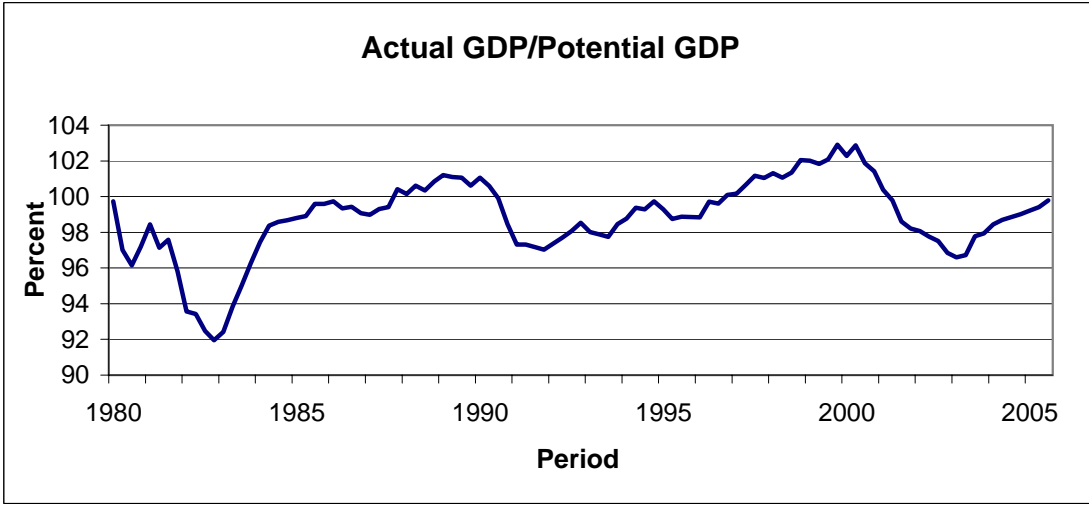
Table 3. Budget Expenditures and Revenues By Major Category, 1980-2005.

percent of GDP

	Discretionary spending			Mandatory Spending			Net Interest	Total Outlays
	Defense	Non-defense	Subtotal	Program Spending	Offsetting Receipts	Subtotal		
1980	4.9	5.2	10.1	10.7	-1.1	9.6	1.9	21.7
1985	6.1	3.9	10.0	10.8	-1.1	9.7	3.1	22.8
1990	5.2	3.5	8.7	10.9	-1.0	9.9	3.2	21.8
1995	3.7	3.7	7.4	11.2	-1.1	10.1	3.2	20.7
2000	3.0	3.3	6.3	10.6	-0.8	9.8	2.3	18.4
2005	4.0	3.8	7.8	11.7	-0.9	10.8	1.5	20.2
	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes	Other Receipts	Total Revenues			
1980	9.0	2.4	5.8	1.8	19.0			
1985	8.1	1.5	6.4	1.7	17.7			
1990	8.1	1.6	6.6	1.7	18.0			
1995	8.1	2.1	6.6	1.7	18.5			
2000	10.3	2.1	6.7	1.8	20.9			
2005	7.6	2.2	6.5	1.2	17.5			

Source: CBO (2005c).

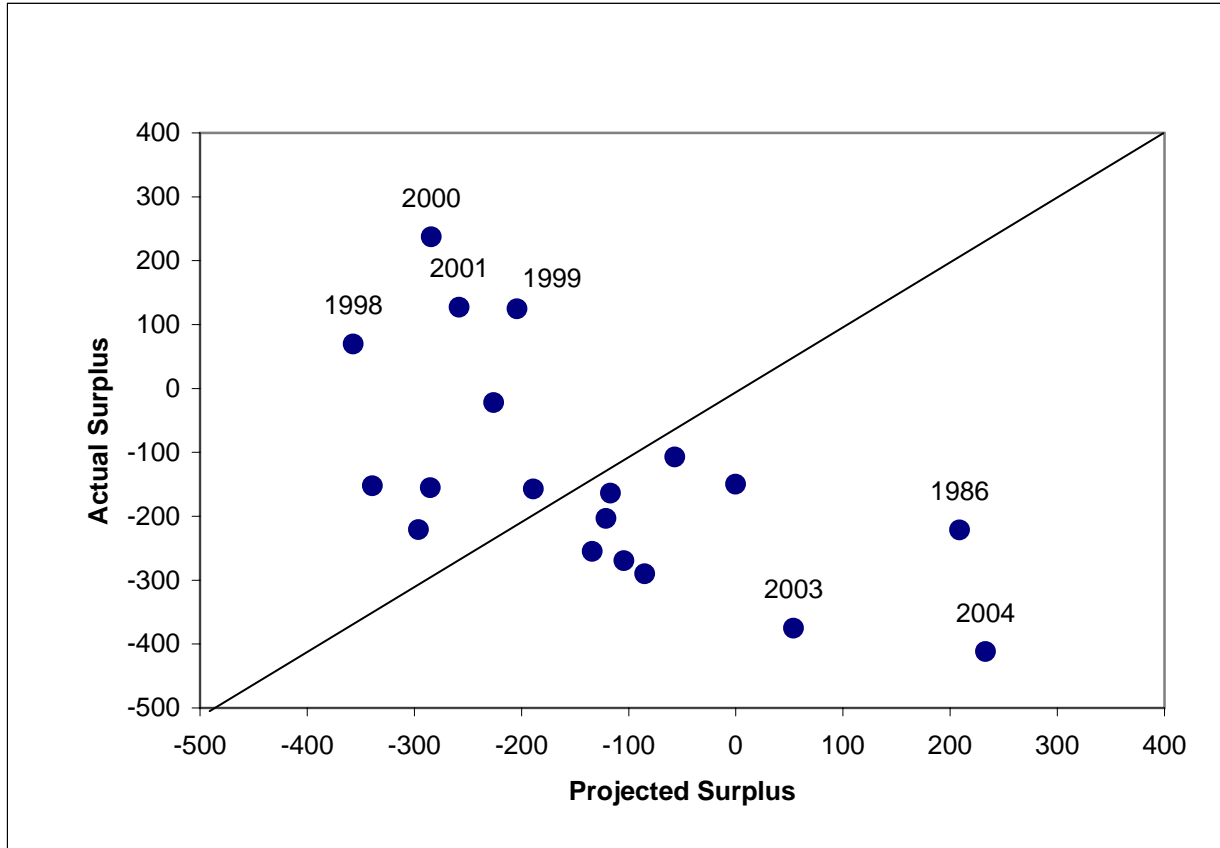
Figure 5. Business Cycle Indicators, and the Effective Tax Rate, 1980-2005.



Source: National Income and Product Accounts.

Figure 6. Actual Budget Surplus vs. 5-Year Projected Surplus, 1986-2004.

Billions of dollars



Source: Congressional Budget Office (2005b) and author's calculations. The projections are based on the budget publication of 5 years prior to the indicated date.

Table 4. The CBO Budget Baseline and Potential Adjustments, 2004-2015.

Budget Adjustment	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1. CBO Unified Budget Baseline, August 2005	-412	-331	-314	-324	-335	-321	-317	-218	-78	-80	-66	-57
as percent of nominal GDP	-3.6	-2.7	-2.4	-2.4	-2.3	-2.1	-2.0	-1.3	-0.4	-0.4	-0.3	-0.3
Adjustment for Expiring Tax prov. (excl. AMT)	0	0	-4	-16	-30	-48	-52	-204	-327	-358	-395	-431
Adjustment for Alternative Minimum Tax	0	0	0	-14	-43	-54	-67	-42	-92	-107	-123	-139
3. Unified Budget adjusted for tax provisions	-412	-331	-318	-354	-408	-423	-436	-464	-497	-545	-584	-627
as percent of nominal GDP	-3.6	-2.7	-2.5	-2.6	-2.8	-2.8	-2.8	-2.8	-2.9	-3.0	-3.1	-3.2
Discretionary spending adjustments	0	0	-2	-4	-5	-5	-9	-21	-45	-70	-96	-126
4. Unified Budget adjusted for tax provisions and discretionary spending	-412	-331	-320	-358	-412	-428	-445	-485	-542	-615	-680	-753
as percent of nominal GDP	-3.6	-2.7	-2.5	-2.6	-2.9	-2.8	-2.8	-2.9	-3.1	-3.4	-3.6	-3.8
Nominal GDP, CBO	11,553	12,271	12,967	13,655	14,373	15,108	15,839	16,581	17,335	18,109	18,908	19,652

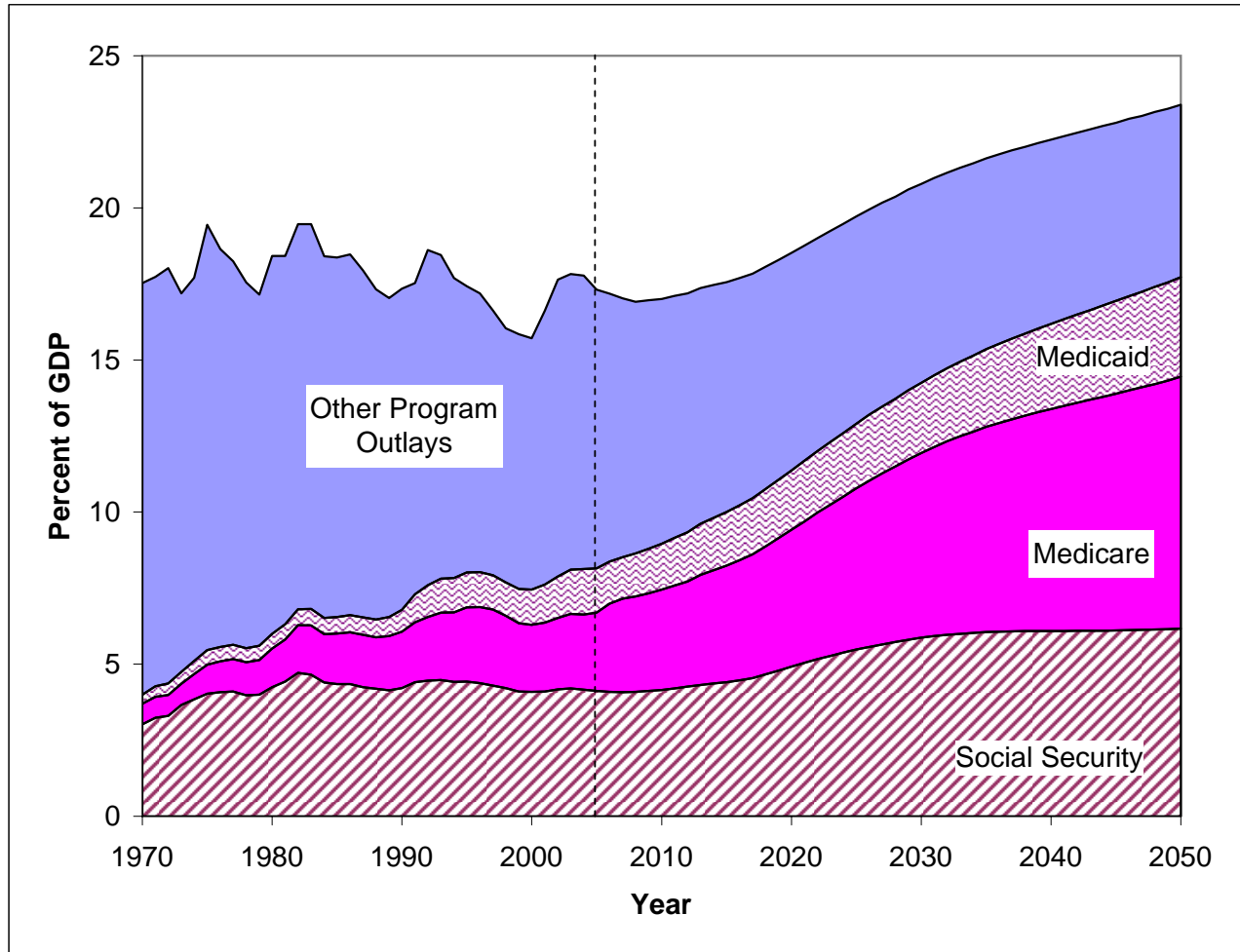
Source: CBO (2005b), table 1-6, and author's calculations

Note: The extension of the tax provisions is assumed to be independent of the the adjustments to the AMT. If both changes are made, there will be an interaction effect that raises the estimate of the revenue loss. In these projections, that cost is assigned to the AMT. The change in the AMT is an indexation of the rates and exemption amount.

a. The discretionary spending adjustment assumes that the supplemental cost of the occupation of Iraq will gradually decline and the remaining portions of discretionary spending will grow at population growth plus 1 percent plus inflation.

Figure 7. Projected Federal Program Outlays, 1970-2050.

percent of GDP



Projected Federal Budget Outlays and Revenues, 1970-2050.

percent of GDP

	1970	1980	1990	2000	2015	2025	2050
Social Security	3.0	4.2	4.2	4.1	4.4	5.5	6.2
Medicare	0.7	1.3	1.9	2.2	3.8	5.3	8.3
Medicaid	0.3	0.5	0.7	1.2	1.8	2.1	3.3
Other programs	13.5	12.4	10.6	8.3	7.6	6.8	5.7
Program Outlays	17.5	18.4	17.3	15.7	17.6	19.7	23.4
Interest	1.5	2.1	3.6	2.7	2.4	3.0	9.4
Total Outlays	19.0	20.5	21.0	18.4	20.0	22.7	32.8
Receipts	17.6	18.6	18.0	20.5	18.4	18.4	18.4
Budget Balance	-1.4	-1.9	-3.0	2.1	-1.6	-4.3	-14.4

Source: CBO (2003).

Table 5. The Present Value of Unfunded Liabilities, Social Security and Medicare, 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
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, C!5, and C21.