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Budget Solutions: Then and Now

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July 19, 2011

Negotiations to tame the outsized U.S. budget deficit have yet to yield a deal. Politicians remain stymied. Not only do they suffer conflicting ideologies, but they also confront a key hurdle: U.S. voters don't want to pay for the government they want to consume.

The stakes for the U.S. economy are growing with each passing day of inaction on the fiscal front. The U.S. needs an epochal shift toward discipline in its public finances. Without it, the inconceivable — default — is now conceivable, as U.S. ratings agencies are beginning to note.

As the Greek crisis and the related threat to the EU should signal to Washington, advanced economies can experience debt crises with all the attendant collateral damage to financial markets. The specter of default is no longer reserved solely for emerging economies, like Russia or Argentina. Rather, amid faltering budget negotiations, it can haunt even the U.S. A default here would be the first for the nation since the mid-1780s when the Confederation of States failed to meet interest payments on its domestic and foreign debt.[2]

Below, we evaluate history to uncover the most successful strategies to tame unchecked deficits. We draw the following conclusions.

- First, although both "discretionary" and "mandatory" spending have fueled the U.S. deficit explosion, entitlement spending is the primary source of future deficit expansion. A budget deal that does not contain "mandatory" spending will fail.

- Second, the lesson from previous deficit reduction efforts – Gramm-Rudman-Hollings (GRH) and the Budget Enforcement Act (BEA) – is that BEA's budget rules provided more effective fiscal discipline than GRH's deficit targets. Such rules will face a greater challenge this time around, though. The deficit is deeper now. Mitigating factors that enhanced rules' success in the 1990s are absent now. Most critically, it will be harder to design and enforce rules to control entitlements than to contain discretionary outlays.

- Third, the greatest deficit reduction historically has been achieved not by rules, but by bipartisan agreements to permanently reform spending and taxes.

The present budget dilemma is the most severe in at least 100 years. History suggests that what failed in the past will likely fail again. Unfortunately, what worked in the past will succeed if and only if a negotiated agreement mandates sweeping changes in spending and definitive shifts in taxes.

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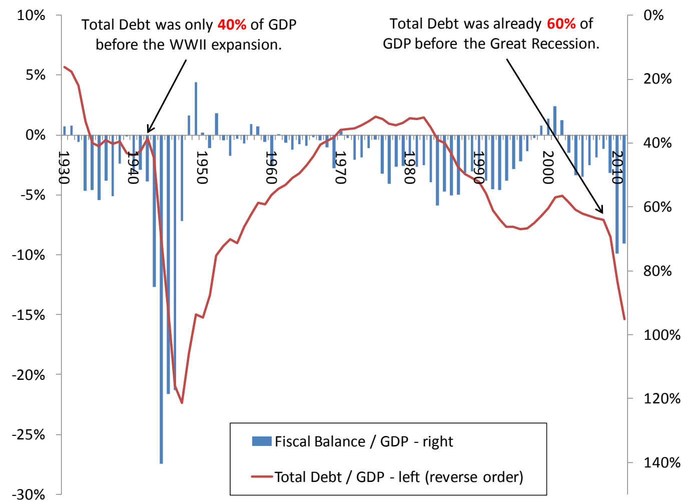
[2] Homer, Sidney. A History of Interest Rates, second edition, p. 278.

The Historical Perspective

The U.S. comes to the current debt ceiling debate with a staggering deficit problem. The federal budget gap topped out at 10% of GDP during the Great Recession and has since dipped only to about 9% of GDP. From an international risk perspective, warning signs flash when the deficit exceeds 4% of GDP. The implication is that the U.S. has strayed from the danger zone into the crisis zone.

Figure 1. Most Vulnerable Debt and Deficit Position in Recent History



Source: Office of Management and Budget, Historical Financial Statistics and Center for Financial Stability Inc.

Only in World War II was the U.S. budget deficit higher (Figure 1). And in that period, the U.S. was better positioned to afford deficit spending related to the war, thanks to a far stronger balance sheet. Notably, public debt in 1940 was a manageable 40% of GDP as against 60% of GDP before the recent global financial crisis.

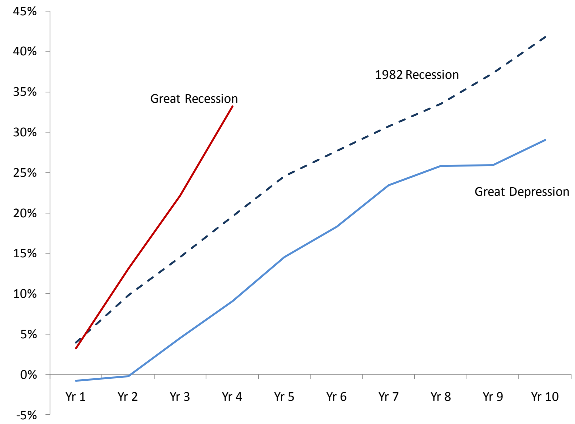
In fact, the US fiscal position is in even worse shape than conventional analysis of the budget suggests. Large refinancings of debt represent an equally severe – yet lesser known challenge. The U.S. faces a bunching of principal payments falling due in the next year. In fact, the U.S. maturity profile is excessively bunched in the short term by comparison with other advanced economies as well as the period in the US after World War II.[3]

The experience of Emerging Markets and some advanced economies suggests that as the budget deficit widens, it is the repayment of principal that often triggers a crisis rather than simply the size of the debt or deficit.

Moreover, the deficit today continues to outpace those in previous downturns. Even during the Depression and the steep early 1980s recession the budget gap never topped 6% of GDP. The cumulative deficit (as a percentage of GDP) in the four years since recession struck in fiscal 2008 already exceeds the ten-year tally for the Great Depression (Figure 2).

[3] Goodman, Lawrence, "Treasury Maturities: The Other Fiscal Problem" – Center for Financial Stability, Inc., March 10, 2011.

Figure 2. Cumulative Deficits in Deep Downturns



Source: Office of Management and Budget, Historical Financial Statistics and Center for Financial Stability Inc.

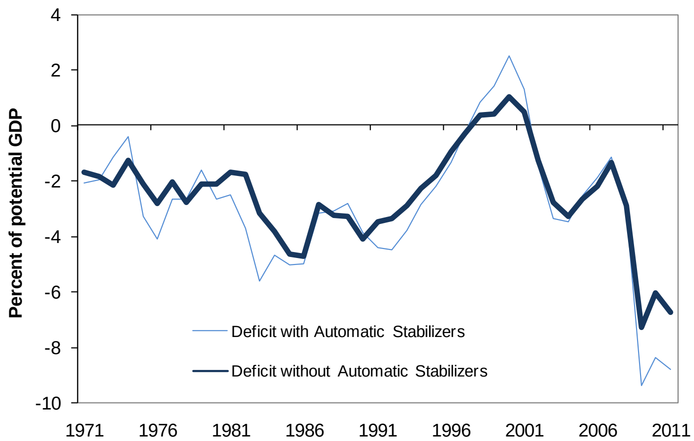
The deficit should shrink in coming years, if the U.S. economy continues to stabilize and unemployment drifts lower, if only very slowly. A gradual drift back toward full employment would eventually boost revenues' share of GDP to at least 16% of GDP. That's true even if the country sustains all of the tax breaks implemented in the last 10 years. And revenues would likely climb by another 1¼% to about 17¼% of GDP, if policy makers permitted some temporary tax breaks to expire, such as the payroll tax and corporate tax breaks implemented last year. Even so, revenues would linger below the long-term average for revenues. Since Medicare and other entitlements threw down roots in the late 1960s, revenues have averaged 18.2% of GDP.

The Structural Deficit Dilemma

The problem for the U.S. is that the current deficit is more structural than cyclical, despite the severity of the recent recession. The Congressional Budget Office estimates that less than one quarter of the 2011 deficit owes to operating at less than full employment. And less than 20% reflects the stimulus measures enacted in 2009 and 2010. Consequently, roughly 60% of the 2011 deficit —about 5½% of GDP—owes to a chronic mismatch between spending and taxes that has emerged over the past decade. Of that more permanent gap, about half derives from the temporarily extended 2001-2003 tax cuts and the perennially renewed alternative minimum tax relief. The balance stems from substantially higher spending.

A rough proxy for the structural budget deficit is the deficit without automatic stabilizers, which is calculated by the Congressional Budget Office (see Figure 3). This measure abstracts from changes in revenues and outlays that are attributable to cyclical changes in output and employment. By this measure, the deficit is 40% bigger than it was in 1985, when Congress enacted the Gramm Rudman Hollings deficit reduction legislation. It is almost 60% larger than it was in 1990 when Congress passed the Budget Enforcement Act aimed at paring the deficit. The bottom line is that in this budget debate, the deficit is starting from a much bigger hole. Moreover, it is a hole that will be hard to fill, partly because it will continue growing and partly because, as has been widely noted, the sources of that growth – old age benefits and health care – are extraordinarily popular with voters.

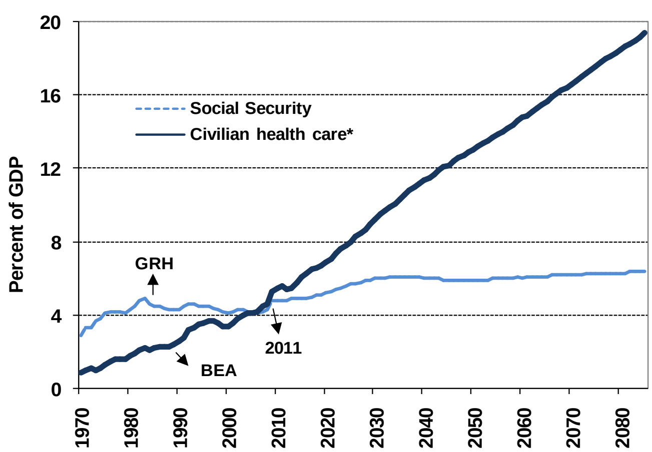
Figure 3. Budget Deficit: Total and Without Automatic Stabilizers



Source: Congressional Budget Office.

Demographics have swung from faintly budget-friendly during the 1980s and 1990s to budget-hostile in the 2010s. Baby boomers are flooding into retirement and promise to send old age spending into the stratosphere.[4] If current policies persist, Social Security benefits will climb by about ½% of GDP over the next 10 years, while spending for Medicare, Medicaid and other health entitlements shoot up by 1 ½% of GDP (see Figure 4). While discretionary spending has helped bloat the deficit over the past decade, it is this explosion of spending that is the key driver of the deepening deficit problem that confronts the United States—and many other developed countries. Revenues, by comparison, are likely to remain relatively stable relative to GDP, absent major changes in current tax policy.

Figure 4. Selected Federal Entitlements



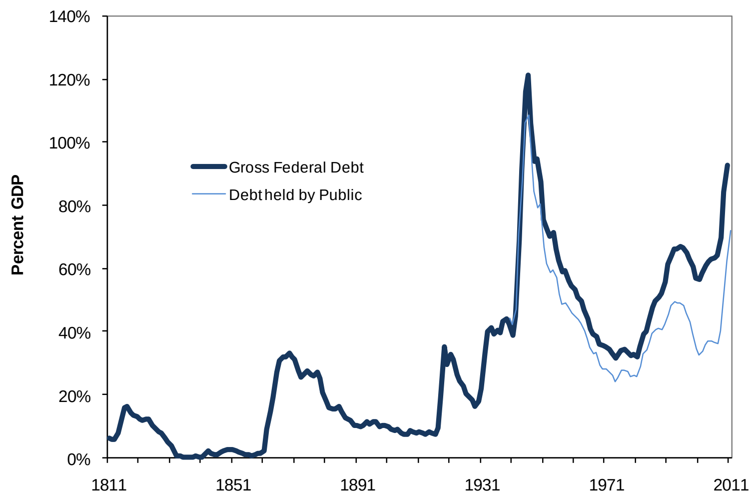
* Includes Medicare, Medicaid, children's health and health care exchange subsidies
Source: Congressional Budget Office.

The current debt ceiling showdown is also distinguished by the exceptionally high level of federal debt. Federal debt held by the public this year will reach a 60-year high near 70% of GDP—more than double

[4] Lumsdaine, Robin L. "The Market for LTC Insurance and Systemic Risk" – Center for Financial Stability, Inc., January 14, 2011

its level just 10 years ago (see Figure 5). Even at this height, the U.S. debt burden (including state and local governments) is about average for advanced countries and less than half as large as the biggest advanced economy debtor—Japan. But the U.S. debt burden is poised to rise significantly further, absent sizable deficit reduction. A more elevated debt burden could be perilous for a nation in which half of the federal debt is owned by foreign investors. For comparison, foreign investors hold only about 5% of Japanese government debt. Moreover, the escalating interest payments that inevitably accompany a burgeoning debt will increasingly funnel federal spending outside the country.

Figure 5. Federal Debt



Source: U.S. Treasury, BEA and CFS

Approach to Budget Solutions

That the U.S. has a serious budget and debt problem is hardly subject to debate. The exact scope of the problem is more debatable. Policy makers must decide first on an objective. Do they try to balance the budget, as they did in previous budget showdowns? Or, given the massive size of the deficit and the pallid pace of U.S. growth, do they try to stabilize the debt's escalating share of GDP or seek to cap the deficit's share of GDP (see Figure 5)?

Stabilizing the debt is probably the most critical objective; that goal does not require a balanced budget. To stabilize the debt held by the public around 70% of GDP, and the gross public debt ratio near the current 93% of GDP, assuming nominal trend GDP growth of about 4 ½% per year, the U.S. would need to run deficits averaging less than 3% of GDP. If policy makers aim for a lower debt ratio—as the IMF would advise—budgets would need to veer closer to balance.

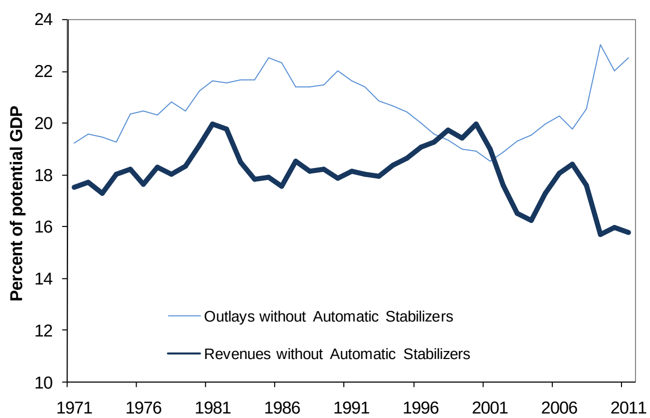
Yet more contentious is how to resolve the deficit problem. There are an infinite number of combinations of higher taxes and lower spending that could restore the deficit to a sustainable level. Some are quite simple – yet we can learn from prior attempts to reduce the deficit.

Washington historically has addressed deficits in two ways: grand budget accords and budget process reforms. Bipartisan agreements to pare deficits have yielded the most important successes. Such efforts produced lasting reforms of Social Security in 1977 and 1983 when the program was in serious trouble. In 1990 and again in 1993, the political parties worked out compromises to narrow the deficit with both spending cuts and tax hikes. The agreements included both immediate and prospective spending cuts and tax hikes, and laid a strong foundation for future deficit reduction.

Budget process reforms have also produced some deficit reduction, but the record has been more mixed.

Gramm-Rudman-Hollings (GRH) – The country tried two deficit reduction methodologies in the 1980s and 1990s. The first approach – the 1985 Gramm-Rudman-Hollings (GRH) legislation – utilized across-the-board spending cuts to reduce the deficit below specified deficit targets. The focus on spending cuts was consistent with the philosophy of the Administration in charge at the time. But the focus also reflected the origins of the deficit: The doubling of the structural deficit in the previous 10 years occurred as revenues (adjusted for automatic stabilizers[5]) dipped by only 0.3% to 17.9% of GDP while spending (adjusted for automatic stabilizers) climbed by 2.1 percentage points to 22.5% of GDP (see Figure 6).

Figure 6. Revenue and Outlays without Automatic Stabilizers



Source: Congressional Budget Office.

The GRH legislation was initially stalled by constitutional objections to the means of implementing the cuts. But even when revamped in 1987, the GRH strategy failed to dramatically reduce deficits. It did trigger several modest across-the-board spending cuts and it facilitated a dip in defense spending. A key problem was that Congress revised up the deficit targets, pushing balanced budgets further into the future. According to the CBO, Congress also resorted to optimistic economic assumptions and "smoke and mirrors" to reach deficit targets –on paper.[6] Not surprisingly, the underlying or "cyclically-adjusted" deficit (which abstracts from swings in taxes and outlays that occur automatically as the economy oscillates around full employment) moved sideways between 1985 and 1990. Adjusted for automatic stabilizers, revenues were flat in those five years, while spending dipped by just 0.5% of GDP.

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[5] Automatic stabilizers are changes in receipts and outlays that occur reflexively as output and employment move cyclically. For example, corporate taxes automatically decline as profits slump in a recession, while jobless benefits and food stamps automatically rise as unemployment expands.

[6] Robert Reischauer, Congressional Testimony before the Committee on Government Operations, May 13, 1993. http://www.cbo.gov/ftpdocs/103xx/doc10382/1993_05_13reischauertestimony.pdf

Budget Enforcement Act (BEA) – In 1990, the slow pace of deficit reduction, reinforced by continued pressure for action from bond market vigilantes, encouraged Congress to enact the Budget Enforcement Act. This legislation set explicit annual targets for discretionary spending (i.e. spending on programs that require regular approval) and required that any new entitlements (programs that enjoy permanent approval) or tax breaks be funded with new revenues. Unlike the GRH attempt, this deficit reduction effort was followed by a steady, sizable slide in the cyclically-adjusted deficit. Indeed, this deficit measure shifted to a surplus in 1997.

The implication is that the new budget rules provided more effective discipline for policymakers than had the more easily subverted deficit targets set by GRH. The actual deficit did not sink steadily in the wake of the BEA; a recession interceded initially. However, even the actual deficit disappeared eventually. In 1998-2002, the U.S. recorded budget surpluses – something the BEA never aimed to achieve.

This remarkable outcome no doubt owed something to the new budget rules. However, economic, geopolitical and financial forces contributed importantly to this unexpectedly robust success – forces that may not be as powerful this time around, even if Congress reverts to the BEA spending rules.

- First, in the 10 years between the enactment of BEA and the peak in the budget surplus, defense spending provided nearly all of the reduction in discretionary spending to 6.3% of GDP from 8.7% in 1990. The end of the Cold War facilitated a 15% reduction in annual defense outlays between 1991 and 1999.

  Planned troop withdrawals from Iraq and Afghanistan offer latitude for a renewed reduction in defense spending now. However, the perceived need for defense spending does not seem to have fallen as sharply as in the early 1990s. Consequently, paring discretionary spending now will likely be more challenging than in the 1990s.

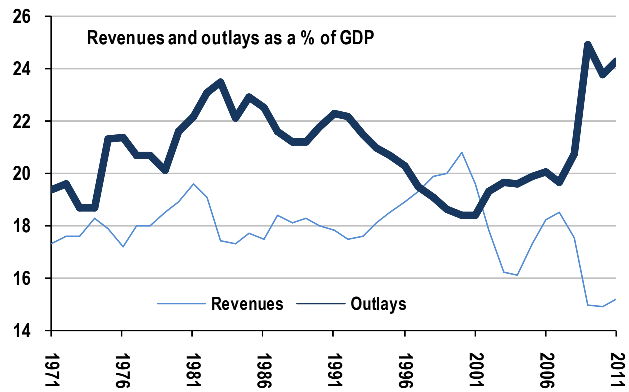
- Second, a secular decline in interest rates helped push Federal interest outlays to 2.3% of GDP in 2000 from 3.2% of GDP in 1990. That drop of close to one percentage point accounted for almost one sixth of the deficit improvement during that decade. With interest rates already hovering near historic lows, it's hard to imagine a comparable contribution to deficit reduction from interest expenses this time around. At best, a very slow rebound in U.S. interest rates from recession-depressed levels is likely to limit the inevitable rise in interest costs as U.S. deficits persist in coming years.

- Third, the emergence of surpluses depended importantly on tax increases approved in 1990 and 1993 (see Figure 7). The Treasury has estimated that these tax hikes boosted federal revenues by about 1.25 percentage points of GDP, based on conditions around the time of enactment.[7] However, these tax bills included meaningful increases in taxes aimed at high-income individuals: they boosted the top marginal tax rates and lifted the ceiling of income subject to the Medicare tax. (We estimate the increase at about $50 billion (in 2011 dollars) at annual rates.) And even as top marginal rates were rising, the distribution of income was shifting

[7] Jerry Tempalski, U.S. Department of Treasury, "Revenue Effects of Major Tax Bills," OTA Working Paper 81, revised September 2006. http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota81.pdf

increasingly toward upper-income brackets. As a result, long-term revenue gains from the early 1990s tax hikes likely exceeded initial estimates. Whether Congress will again focus revenue increases on the well-to-do remains a subject of substantial disagreement. At a minimum, though, there is no guarantee that the distribution of income will continue to shift as rapidly toward upper-income earners, reinforcing the revenue bang from any upper-income tax hike.

Figure 7. Revenue and Outlays, % of GDP



Sources: Office of Management and Budget and CFS.

- Fourth, the budget benefited from unexpectedly brisk economic growth in the latter1990s. In 1991, the Congressional Budget Office anticipated that real GDP would expand by only 2.1% on average between 1990 and 2000. Five years later, the CBO was still projecting a scant 2% average growth for the decade. In fact, real GDP expanded at a 3.4% (calendar year) annualized clip over those 10 years. As a result, cyclically sensitive outlays were lower and revenues higher than expected, yielding consistently lower deficits—and eventually bigger surpluses—than the CBO projected. An equity bubble reinforced the deficit surprise by bloating capital gains tax collections. The constant downside surprises on the deficit indirectly helped to contain the urge to spend and to cut taxes; Congress constantly anticipated bigger deficits than eventually materialized.[8] There is no guarantee that budget forecasts errors will be so consistently favorable in the next 10 years.

- A final factor that helped pare deficits in the 1980s and 1990s was financial market pressure. So-called bond market vigilantes kept the deficit in the spotlight, and threatened policymakers with sharply higher interest rates, and potentially sharply lower growth, if Washington veered away from prudent fiscal policies, despite a broad-based acceptance on Capitol Hill that deficits were unsustainably high.

Unfortunately, bond market vigilantes have been absent for years – at least as evidenced by interest rate gyrations. Bond yields in the United States recently display no clear link to deficit trends. The apparent absence of this pressure could impede progress toward deficit reduction in the coming decade. Even though policy makers appear as acutely aware of the deficit problem now as they were in the 1980s, relations between the political parties are so fraught now that external pressure might be yet more vital to force a deficit reduction deal.

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[8] As soon as surpluses emerged in 1998, discretionary spending accelerated. The implication is that dire deficit forecasts provide an inherent restraint on the deficit—at least in non-crisis periods.

Concluding Thoughts: Going Forward

Europe's deep distress is a wake up call for America. The time is now for a meaningful and lasting solution to unchecked fiscal deficits.

The reality is that the bulk of the adjustment is due on the spending side. It is spending that is threatening to explode as the country ages. Health care entitlements such as Medicare and Medicaid cannot forever outpace the rest of the economy.

A grand budget accord that permanently reforms spending and taxes would be the most effective strategy to return the deficit to a sustainable path. It should be buttressed with budget process rules to sustain future budget discipline. And those budget rules must focus on entitlements, which lie at the heart of the exploding deficits. Drafting and adhering to those rules will pose a singular challenge for U.S. policymakers. They confront deeper deficits than their counterparts in the 1980s and 1990s. And they can expect less help from economic, geopolitical and financial forces in moving toward more balanced budgets.

With thanks to Dana Johnson, Robin Lumsdaine, and Bruce Tuckman.

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