

Federal Budget Realities and the Need for Policy Reform

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*The debate about the federal budget during the Presidential election was predictably frustrating, focused on the short run and full of mudslinging about the shift from cash-flow surplus to deficit. In fact, spending on key entitlement programs has significant built-in momentum, and both political parties have advocated expanded spending programs. With the election season over, now's the time to enact structural reforms that improve program efficiencies and narrow the government's long-run financing imbalance.

*The return to budget deficits reflects legislated increases in spending for defense and continued growth of entitlement and mandatory programs, along with the unprecedented fall in tax receipts that was attributable largely to the 2001 recession and adjustments to the 1990s. Although the deficit is now shrinking from its Fiscal Year 2004 peak, the composition of outlays severely constrains the ability to achieve material short-run cuts or to impose 1990s-style "pay-go" rules that would be effective.

*The cash flow deficit is only the tip of the iceberg: the government's long-run budget imbalances, which are driven primarily by the impact of adverse demographics on the government's liabilities for Social Security and Medicare, are enormous. Their magnitudes overwhelm the more closely followed short-term budget deficits.

*Just because deficits may not materially affect interest rates or inflation in the short run doesn't mean they are harmless. Sustained deficit spending for entitlement and retirement programs and the growing claims of these programs on future workers' incomes will affect long-run economic performance and standards of living.

*Fiscal policy makers must go beyond political rhetoric and enact structural changes in key entitlement programs. Incremental changes, particularly in Medicare, will prove inadequate, and heavy reliance on tax hikes in an attempt to close projected budget imbalances would adversely affect economic growth, potentially widening the financial shortfall and jeopardizing the long-run sustainability of these programs.

*The Bush Administration economic policy agenda will focus on reforming Social Security and consolidating retirement programs, reforming health care financing and liability law, and making the tax cuts permanent. If crafted properly, these programs would increase economic efficiency and close the government long-run budget imbalance, but rational rules of public finance must dominate political bullying, particularly in light of short-run deficit concerns.

Unfavorable Budget Trends: Political Expedience Trumps Fiscal Responsibility

Recent federal budget trends put the current budget debate into context and validate skepticism about whether fiscal policy makers will readily enact programmatic reforms of key government programs required for financial soundness. Short-run political expedience trumps

fiscal responsibility: neither the cash flow budget surpluses of the late-1990s or the recent deficits have led policy makers to seriously debate, much less resolve, fundamental fiscal issues. The unwillingness to tackle critical long-run strategic issues has allowed the long-run budget imbalance and associated problems to mount.

The trend from cash flow deficits to surplus in the 1990s was driven by several key factors that are unlikely to be repeated any time soon: the post-Cold War “peace dividend” afforded defense spending to fall sharply (from 5.6 percent of GDP in FY 1989 to 3.0 percent in 2000), and robust economic growth and an explosive stock market generated dramatic increases in tax receipts (see Chart 1). Also aiding the trend were cuts in nondefense discretionary spending programs and legislated tax hikes in 1990 (President Bush Sr.) and 1993 (President Clinton). The cash flow surplus in 2000 was as unsustainable as were the economic and stock market conditions of the late 1990s. Tax receipts had risen to 20.9 percent of GDP, their highest level in recent history, reflecting largely the surge in personal income tax receipts to a record-breaking 10.3 percent of GDP, several percentage points above its 40-year average. Measured as shares of GDP, the decline in defense spending constituted more than 100 percent of the decline in total federal spending less net interest outlays.

Two trends during the 1990s that are often overlooked are coming home to roost and spell trouble for the future. Firstly, the composition of spending evolved significantly, as outlays for Social Security, Medicare and Medicaid continued to grow rapidly and rise as shares of total budget outlays, while spending for defense and nondefense discretionary programs, including many for education and research and development, shrank (see Chart 2). Secondly, while the cash flow budget improved, the government’s long-run budget imbalance continued to grow, as fiscal policy makers made no headway in addressing entitlement programs’ structural flaws.

On the state level, fiscal problems surfaced immediately. States are mandated to share heavily in the cost burdens of Medicaid, for which Congress legislated program expansions; in the 1990s, increased costs for Medicaid were the largest source of spending increases for many states. Also, in select states, elected officials perceived the accelerating tax receipts of the late 1990s as a “political windfall” and enacted new programs that add permanently to spending.

My November 2000 report to the SOMC, entitled “Budget Surpluses and the End of Fiscal Restraint,” emphasized the fiscal laxity that would stem from the “politics of surplus” and also noted the changing composition of government outlays that made fiscal restraint so difficult. In fact, since 2001, a large portion of the cumulative spending increases has been attributable to the built in momentum of entitlement spending, but the revealed preference of both political parties has been expanded spending programs. Both parties have advocated significant increases in spending for defense and national security. Both enacted the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 that is generating a significant increase in Medicare spending. Neither political party has recommended any material modifications to Medicaid, the fastest growing spending program in the federal budget. Regarding Social Security, the Democratic Party recommends no change, while the

Republican Party's reform proposal would reduce the program's long-run unfunded liability but would involve higher cash flow budget deficits during implementation.

During 2001-2004, federal outlays increased over 23 percent. The composition of the rise is instructive (see Table 1). Defense spending surged: following a 12 year period in which current dollar spending for defense was unchanged (outlays of \$306 billion in FY2001 were virtually the same as in 1989), defense outlays rose \$146 billion during 2001-2004, contributing 34 percent of the rise in total government outlays (Defense budget authority rose even more, and that authority will contribute to defense spending in coming years). Another 29 percent of the cumulative spending rise was attributable to increased outlays for Social Security and Medicare (up \$122 billion, a cumulative 28.5 percent), while Medicaid spending increases contributed 11.2 percent of the total increase. Income support programs, which include unemployment compensation, supplemental Security Income and other cyclically sensitive programs, rose \$48 billion, or 11 percent of the total increase. The momentum for rising spending built into the entitlement programs has become an increasingly powerful component of government finances.

During 2001-2003, there was an unprecedented decline in federal tax receipts. This reflected primarily a fall in personal tax receipts generated by the 2001 recession and subsequent decline in employment in 2002, and the drop in capital gains tax receipts. Only a small portion of the decline was attributable to the legislated tax cuts of the Economic Growth and Tax Relief Reconciliation Act of 2001.

The deficit peaked in FY2004, at approximately \$413 billion; its 3.8 percent share of GDP was well below 1983's record 6.0 percent and close to the 3.7 percent average during the 20-year period 1975-1995 (see Chart 3). In 2004, both outlays and tax receipts were smaller shares of GDP than virtually all years going back to 1975. Government outlays were approximately 20.1 percent of GDP and 18.4 percent excluding net interest, compared to outlays of 20.7 percent of GDP in the 1990s, 17.7 percent excluding net interest. Tax receipts were approximately 16.2 percent, well below their 18 percent long-run average.

The publicly-held government debt, which troughed at 33.1 percent of GDP in 2001, has increased modestly to 37.5 percent in 2004, and is projected to gradually rise to 40 percent (see Chart 4). The ratio is low compared to the government debt burden in other industrialized nations. Government finances is benefiting from low interest rates, and more precisely, interest rates that are significantly below nominal GDP growth. In 2004, net interest outlays were about 7 percent of total government outlays, well below their 10 percent average since the early 1960s and less than half their 1989 peak.

Under current law, the budget deficit is projected to recede significantly as tax receipts accelerate while spending remains rapid in 2005-2006 and then moderates. Our deficit projections are \$360 billion in 2005 and \$320 billion in 2006 (2.9 percent and 2.5 percent of GDP), and then receding modestly further in subsequent years. Tax receipts are accelerating with stronger economic activity; the pick up in nominal GDP provides a boost to overall tax receipts, and although employment gains have been soft, faster increases in aggregate hours worked have lifted personal income taxes. Under current law, the CBO projects tax receipts

to rise 11.9 percent in 2005 and 8.8 percent in 2006, reflecting healthy economic expansion and the sunset of selected legislation. Within five years, tax receipts are projected to rebound to 18 percent of GDP, their long-run average. Government spending is forecast to grow at a 6 percent pace in 2005-2006 before slowing to a sub-5 percent annual pace in subsequent years. Defense spending will continue to grow rapidly, reflecting the lagged impact of the sharp increase in budget authority in 2002-2004.

Comment on the Implications of Recent Fiscal Trends

Fiscal policy and deficit spending affect economic and financial market performance in many complex ways that cannot be determined by simplistic assessments based on the magnitude of deficits (or debt) or their changes. Rather, the composition of government spending and the tax structures underlying government finances, and what the spending and tax structures imply for the allocation of national resources and the incentives they generate, are crucially important. Impacts may defy conventional notions. Depending on the allocative effects of the tax and spending structures, deficit spending (or changes in deficits) may contribute to rising or falling inflation, and/or rising or falling interest rates and exchange rates.

The government's finances in the 1990s, particularly the change in the composition of outlays, provide a good example of these complexities. The headline trend was the shift from deficit to surplus, which by commonly-held notions would have been associated with fiscal restrictiveness and slower economic growth, falling real interest rates, a narrowing current account deficit and a lower U.S. dollar. However, other important shifts in government's finances occurred that affected economic and financial behavior. The amount of national resources the government directly absorbed declined as defense spending shrank as a share of GDP; all of the increases in spending were transfers that redistributed income and wealth among citizens (for example, Social Security redistributes FICA taxes from workers to retirees, but does not directly absorb resources) or financed medical services (Medicare and Medicaid). The freeing of resources directly absorbed by the government contributed to outsized increases in private consumption and investment as their shares of national income rose. This added to GDP growth and productivity gains. The robust productivity gains and higher potential growth along with the Federal Reserve's monetary policy contributed to lower inflation and eased inflationary expectations, while the stronger economic performance and higher expected rates of return on investment pushed up real interest rates. Thus the dramatic shift from budget deficits to surplus did not lower real interest rates, in line with the commonly-held view that deficits and interest rates are positively correlated. Moreover, the budget surplus was accompanied by a soaring current account deficit, also contrary to conventional notion and the "twin deficit paradigm," as private domestic saving receded while national investment boomed, and the U.S. dollar appreciated, reflecting the high risk-adjusted rates of return on U.S. dollar-denominated assets.

The monetary ease and tax cuts of 2001 were timely and effective countercyclical policies that reduced the magnitude of the recession, and along with the tax cuts of 2002 and 2003, contributed to the economic recovery. The 2001 tax cuts were somewhat diluted by

their retroactive and temporary nature. Virtually every major tax cut provision is scheduled to “sunset”, creating uncertainty and in some cases distorting economic decisions. Of current importance, scheduled expiration of the bonus to depreciation of new capital at year-end is affecting the timing of business investment, and the temporary reduction of the cost of capital does not add significantly to long-run investment.

The shift toward record-breaking budget deficits since 2001 has been accompanied by receding inflation and the lowest interest rates since the early 1960s, contrary to conventional wisdom. Even though the deficit spending has not driven up interest rates, the underlying spending and tax structures can be expected to affect economic performance.

Defense spending directly absorbs national resources, and since 2001, defense spending has risen nearly a full percentage point of GDP. Eventually, the rising share of national income allocated to defense and national security will squeeze the shares of private consumption and investment. To date, these crowding-out effects have been delayed by the acceleration in nominal GDP, but they will begin to unfold as national income growth stabilizes.

The government’s financing of medical services also has important allocative effects. While the government’s spending on Medicare and Medicaid does not directly absorb national resources like defense spending (or like when a local government builds a schoolhouse), it is associated with the provision of medical services. As enhanced government subsidies for medical services (like the Medicare Prescription Drug, Improvement, and Modernization Act of 2003) increase their supply and demand, medical care will absorb a larger share of national resources. Presently, they account for over 14 percent of GDP in the U.S., by far the highest among all industrialized nations. In hindsight, with 2001 likely the low in defense spending as a percent of GDP, and with no material change in the structure of the government’s Medicare and Medicaid programs, along with the aging population, a rising share of national income can be expected to be allocated to defense and medical services. Insofar as the shares of GDP add up to one, eventually this will squeeze the shares of non-medical private consumption and investment. The impacts of these trends on productivity and sustainable potential growth are ambiguous, insofar as technological innovations in the medical services industries tend to be rapid but their productivity enhancements are very difficult to measure.

Long-run Government Budget Imbalances

The government’s long-run budget imbalance, which reflects the future costs of government programs under current law, is so large it’s hard to comprehend. The vast majority of the long-run imbalance reflects the “unfunded liabilities” of Social Security and Medicare plus contingent liabilities such as those for the Pension Benefit Guarantee Corporation. The real dilemma posed by the enormous long-run budget imbalance is the overwhelming portion of it that is attributable to Medicare, and the extraordinarily thorny issues involved in correcting current Medicare law to make the program financially sound in an efficient and fair way.

The notion that the Social Security and Medicare programs have enormous “unfunded liabilities” is based on their projected long-run benefits less “earmarked” tax receipts. In fact, these “contributions” or taxes earmarked for the programs’ trust funds in reality go into the government’s general fund, and the trust funds are merely bookkeeping entries (This means that in reality the surpluses in the trust funds are IOUs, and the interest earned on the investment of the surpluses in U.S. Treasuries are also IOUs). The government’s power to tax implies that the government will finance the programs’ benefits when payments are due, regardless of the book entry accounting balances in the trust funds, either through taxes or borrowing. Accordingly, the government’s ability to finance the benefit obligations ultimately depends on economic growth. Under reasonable assumptions about sustainable growth, dramatic increases in projected benefits under current law are ominous. Federal Reserve Chairman Greenspan recently captured the concerns of many, stating: “If we have promised more than our economy has the ability to deliver to retirees without unduly diminishing real income gains of workers, as I fear we may have, we must calibrate our public programs so that pending retirees have time to adjust through other channels.” (Federal Reserve Bank of Kansas City Economic Symposium, August 27, 2004).

Recent estimates of the long-run budget imbalance terms, measured in present value terms of expected government obligations less tax receipts relative the present value of projected GDP, center on approximately 6 percent of GDP. Approximately 75 percent of the estimated long-run budget imbalance is due to Medicare, with Social Security the bulk of the remainder. These estimates are very sensitive to underlying assumptions. Health care outlays per beneficiary are assumed to grow one percentage point faster than real GDP per year. This assumption is considered reasonable, based on the historic trend, and faster increases in medical care costs would significantly raise the budget imbalance. Social Security’s long-run budget problems are smaller and more predictable than those of Medicare, driven primarily by demographics and influenced by long-run assumptions about labor productivity and real wages.

Other estimates that include a broader set of contingencies and liabilities such as the government’s explicit and implicit guarantees of the Government Sponsored Enterprises (including Fannie Mae and Freddie Mac) and various disaster relief programs put the total annual budget imbalance as high as 7.5 percent.

The whopping imbalance poses a huge obstacle to fiscal soundness. Importantly, estimates of how much taxes need to rise to close the fiscal gap are simplified arithmetic exercises that miss the crucial point that the negative economic responses to significantly higher taxes would reduce potential economic growth. Relying heavily on higher taxes may not close the budget imbalance. Instead, structural changes in Medicare and Social Security are required.

An Agenda for Reform

The Bush Administration’s second-term economic policy agenda will have several key thrusts: Social Security reform and consolidation of the retirement saving programs, making the tax cuts permanent, and reform of health care financing and medical liability law. While

President Bush will have the leverage of working with a Republican Congress, these reform initiatives will be constrained by the “politics of deficits”.

President Bush’s Social Security reform proposal involves gradually implementing a partial privatization while continuing to provide basic income support for the elderly. Initially, every employee would have the option of diverting a small portion of FICA contributions (2 percentage points out of each employee’s current 7.6 percent) into a segregated account (that under current law goes into the government’s general fund and Social Security trust funds accounting ledger). Employees would have the flexibility to invest in a menu of stock or bond funds, including the option of investing only in U.S. Treasury securities. Social Security would continue to pay benefits on historic FICA contributions and future contributions that do not go into employee accounts. Social Security’s benefit structure would be adjusted down to reflect the amount going into individual employee accounts. By definition, the portion of payroll taxes diverted into personal accounts will support “funded liabilities”, so as a result, the government’s long-run unfunded Social Security liabilities would be reduced. However, the diversion of FICA contributions from the government’s general fund would increase short-run cash-flow deficits, presumably requiring the issuance of government bonds, creating a political difficulty.

The objective of Social Security reform is to strengthen the program and guarantee its long-run financial viability. The proposed partial privatization, which would take over a generation to implement, would contribute to the program’s long-run soundness, and insofar as the measured unfunded liabilities will continue to widen under current law, the benefits outweigh the temporary costs of higher cash-flow deficits during the transition period. This partial privatization should be augmented by necessary modifications to Social Security’s benefit structure to ensure the basic income support of low-income elderly. In addition, the retirement age should be gradually increased to reflect longer lives. Such changes have been implemented successfully in other nations. Insofar as it is widely acknowledged that the aging demographics make Social Security’s long-run financing unsustainable, the best way to ensure program soundness is quick enactment with reasonably long implementation.

The tax reform agenda must address the sunset of virtually all tax cut provisions and the larger tax bite that will be imposed by the Alternative Minimum Tax as its exemption is reduced under current law. It should also readdress the inefficiencies and complexities of the corporate income tax. The budget context for tax reform will be difficult: tax receipts currently are below their long-run average share of GDP; under current law, which assumes higher effective taxes with the sunset legislation, the tax share of GDP is projected to rise back to its historic average, but even then budget deficits would persist. The optimal tax system is one that raises necessary revenues and is efficient, fair, simple and predictable. Making some portion of the tax cuts permanent should be accompanied by reducing selected deductions, exemptions and credits that would broaden the tax base and reduce economic distortions. Reducing the tax bias against saving requires further enhancement of tax deferred savings plans that heighten the emphasis on consumption as the basis for taxation; this may also affect decisions about the structure of tax rates. Broadening the tax base is additionally important in the context of expanding tax deferred Health Savings Accounts (HSAs) and

retirement savings plans. These reform initiatives should be considered in coordination with Social Security reform.

The Bush Administration's initiatives for reforming health care financing and tort law would represent a small but necessary first step in the direction of increasing efficiencies in medical services and constraining costs. Health care financing reform would expand the HSAs created by the Medicare Prescription Drug Act of 2003 and allow tax credits to low income individuals to purchase health insurance. The HSAs, which would be tax exempt, would allow individuals to purchase their medical services and manage their own medical finances. Small businesses would be allowed to band together to improve bargaining power in purchasing health insurance for themselves and their employees; moreover, additional tax credits would be provided to employees of small businesses to establish HSAs. By reducing the reliance on the government's third-party payments, heightened financial incentives will encourage more judicious demand for medical services and presumably would lead to heightened competition among providers and more efficiency.

Reforms to enhance efficiencies in the provision of medical services include tort reform, which would establish caps on liability damages. Limits on liabilities are presumed to reduce inefficiencies, unnecessary and wasteful provision of medical service, and stem the eroding impact of soaring medical liability premiums on the supply of doctors. Several states already have established caps on malpractice settlements.

In light of the aging population, it is uncertain how much such health care financing reforms would cut into the sharply rising costs of health care and Medicare's staggering long-run financing gap. Nevertheless, reduced reliance on third party payments and increased out-of-pocket costs at point of provision of medical service is a crucial element to meaningful reform. Along with encouraging catastrophic health insurance coverage to spread the risk on low probability but very costly medical events, these measures would constitute important steps in the right direction.

Table 1

Sources of the Spending Increases Fiscal Years 2001-2004

Spending Category	Spending Increases* Annualized		
	in Bil \$	% ch	% of Total
Total	429	7.1	100.0
Defense	146	13.8	34.0
Entitlements & other	238	7.3	55.5
Social Security	63	4.6	14.7
Medicare	59	7.7	13.8
Medicaid	47	8.0	11.0
Income Support	48	10.2	11.2
Other Retirement	20	5.4	4.7
Other	24	17.4	5.6
Offsetting Receipts	-23	8.2	-5.4
Net Interest	-47	-8.3	-11.0
NonDefense Discretionary	92	8.3	21.4

* Note: Based on Congressional Budget Office estimates for FY2004 outlays

Chart 1

Government Spending & Tax Receipts as a Percent of GDP

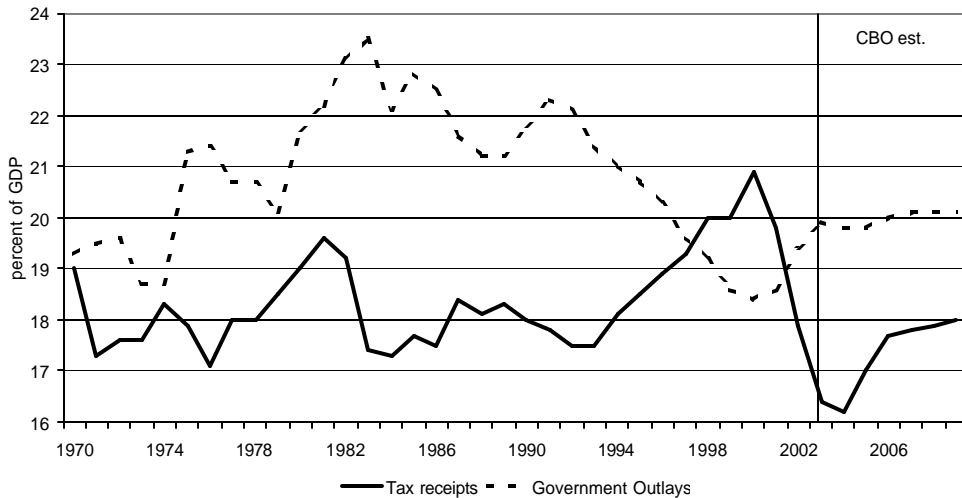
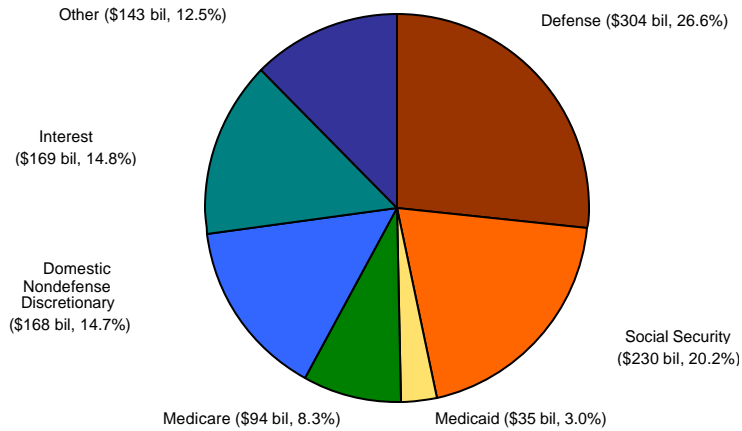


Chart 2 Federal Budget – 1989 Total Spending \$1.143 Trillion



Federal Budget – 2003 Total Spending \$2.158 Trillion

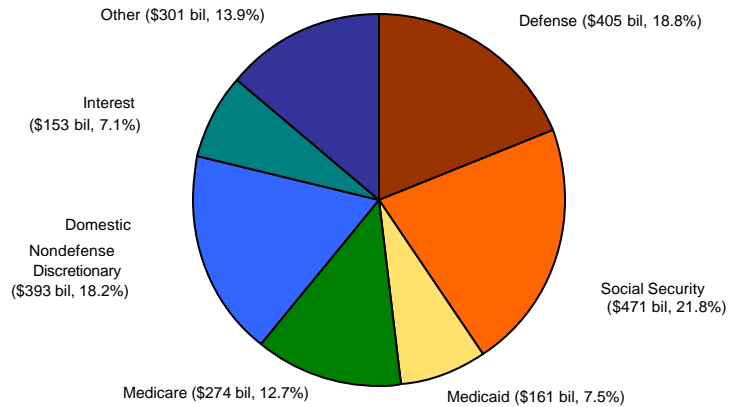


Chart 3

Deficits (-) as a Percent of GDP

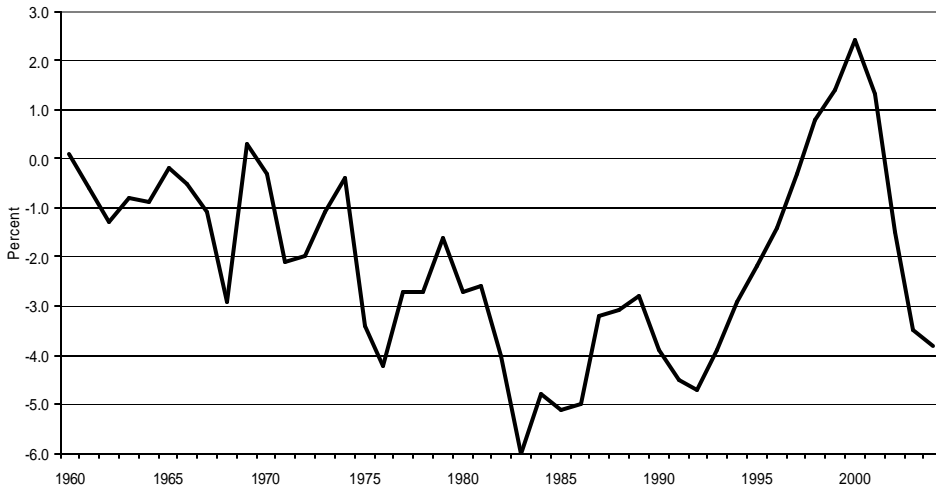


Chart 4

Publicly-Held Government Debt as a Percentage of GDP

