

Fiscal Slack (Part 1 of 2) Part One: Historical Perspective

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Document date: August 21, 2000
Released online: August 21, 2000

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During the Constitutional Convention, one delegate proposed that the U.S. never have a standing army of more than 5,000 troops at any one time. George Washington supposedly leaned over to another delegate and suggested that the provision be amended to read that no foreign army should ever invade the United States with more than 3,000 troops at any one time.

I relate this anecdote because it tells us something about both planning too much for the future and then granting those plans legal or constitutional standing. I contend that there is one striking fiscal dilemma facing almost every government in the industrial world—one that unites them closely. It is not the inequitable or inefficient distribution of tax burdens or expenditure benefits, however large. It is not the coming into power of any particular political party, however weak. The dilemma affects right and left, Democrats and Republicans, liberals and conservatives, labor parties and Christian Democrats. Moreover, the inability to deal with it explains at once why promises made in the current presidential campaign are so hard to interpret. Neither major American political party is able to express how it will tackle this problem, thus forcing the voter to hold in suspense how much of the tax and spending promises of either candidate can be met.

The dilemma I'm referring to helps explain several features of the modern political landscape ranging from elected representatives leaving government and complaining about a lack of power to the disenchantment of the public with government in general. The dilemma can best be described as the lack of fiscal slack—the inability to shift resources either to the greatest needs of society, or at least to what the citizenry at a point in time considers most important. It is reflected in no small part by the proportion of government revenues available for new domestic initiatives that respond to current demands. As the discretionary part of the budget has declined—and is scheduled for further decline under proposals from both parties over the long term—it is not surprising that elected officials feel a loss of control, voters feel disenchanting, and the budget becomes harder, not easier, to manage.

It might sound funny to talk about the lack of fiscal slack during a period in which debates center on how to spend a surplus. But the projected surplus is a temporary phenomenon, largely brought about because baby boomers have filled the labor market, while the far smaller Great Depression-World War II generation fills the ranks of the elderly.

Let's take a short look at fiscal policy since World War II. From the end of that war to the mid-1970s there were both large surpluses and extraordinary fiscal slack. Vigorous economic growth, of course, was one source of new opportunities. Yet economic boom could not explain how domestic public spending at all levels of government could increase by close to 15 percentage points of GDP—an increase in today's dollars of more than \$13,000 per year per household from the late 1940s to the late 1970s. Faster GDP growth does not necessarily bring about any increase in the percentage of GDP to be spent.

Several factors were at play. First, there has been a long-run decline in the defense budget from about 14 percent of GDP at the end of the Korean War to around 3 percent today. That defense decline has allowed about \$1 trillion annually to be shifted toward domestic spending without any significant increase in average tax rates. Rising inflation until the late 1970s also brought down the real value of government bonds. The income tax was not indexed for inflation, so bracket creep, due to both inflation and real growth, created large amounts of revenue growth. And large social security tax increases, which continued until 1990, were accepted in no small part because most individuals would be paying net negative social security taxes when their benefits were compared to the taxes they paid. The many domestic spending increases and tax cuts of that period were all responses to this extraordinary level of fiscal slack.

Starting in the mid-1970s, things began changing. Slower economic growth led to less new revenue. Defense spending declines as a percentage of GDP were temporarily halted in the late 1970s and early 1980s. The approximately three-percentage-points-per-decade increase in social security tax rates came to a halt in 1990. As the social security system matured, no longer could winners so easily be created simply by passing rising burdens onto future generations. Declines in the rate of inflation led to an increase, rather than decrease, in the value of old government debt, as well as relatively high real interest rates for some time. And bracket creep in the income tax was reduced to real, rather than inflationary, increases by the mid-1980s.

For the record, even slower economic growth combined with the drying up of all easy financing wasn't enough to cause the large deficits of the 1980s and early-to-mid-1990s. Real federal revenues per capita still rose from about \$3,800 in 1973 to \$5,200 in 1993. The deficit crisis couldn't and didn't come from the slowdown. It came from the growing level of commitments made far into the future.

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