

## ARE CURRENT BUDGET DEFICITS MORE WORRISOME THAN THOSE OF THE 1980s?

The following **Special Report** was written by our Washington Editor, Dr. Rudolph Penner. Dr. Penner is currently a resident scholar with the Urban Institute, a nonpartisan public policy research organization in Washington. He has been a prominent and influential analyst of budget policy for the past two decades. He was director of the Congressional Budget Office during the mid-1980s and has recently written a book describing the debt explosion of that era, "**The Great Fiscal Experiment.**"

In the following article, Dr. Penner argues that the political response today to the deteriorating budget situation is much different from the 1980s. In the 1980s and early 1990s, Congress worked vigorously to restore fiscal responsibility. There is little evidence of that occurring today and that makes the current situation much more worrisome than in the 1980s. One caveat is that revenues have become particularly difficult to forecast, making it especially difficult to assess the seriousness of the problem.

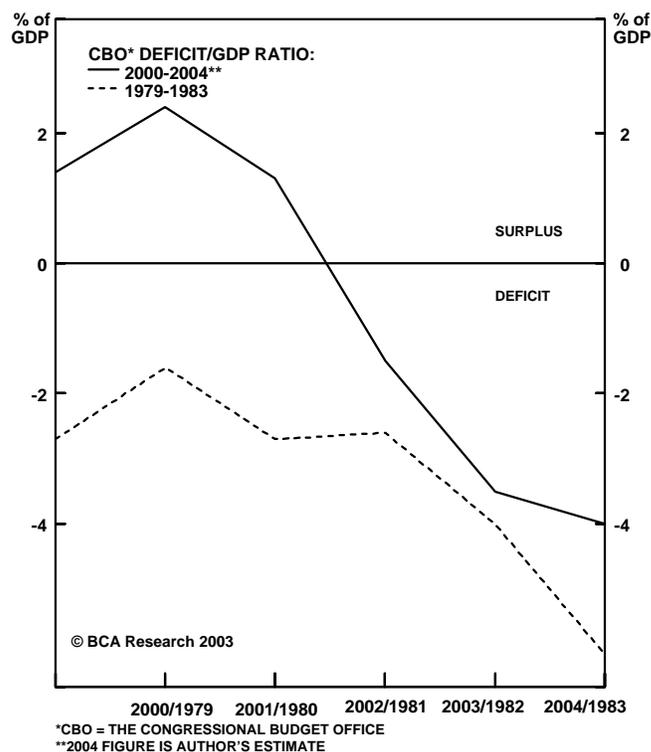
Policy is unlikely to be reversed until the financial community begins to agitate for deficit reduction or unless old-fashioned fiscal conservatives in Congress gain power in next year's elections. In terms of financial markets, fiscal policy will contribute about 1 percentage point to GDP growth in 2004, and will continue to exert upward pressure on interest rates at least through 2005.

Mark McClellan  
Managing Editor

The budget deficit quickly soared from 1.6 percent of GDP in 1979 to 6.0 percent in 1983. However, as early as 1982 the deterioration of the budget balance became evident and a political reaction set in. Over the period 1982-84, the Congress passed a series of significant tax increases and became cautious regarding spending growth. Their politically courageous efforts bore little fruit at first and were set back severely by the recession of the early 1990s. But a surplus in 1998 was finally produced following deficit reduction packages in 1990, 1993 and 1997, combined with the positive legislative actions of the 1980s and an economic boom.

In the current episode, the budget deficit is not likely to exceed the 6.0 percent of GDP reached in 1983 – if we are lucky – but the deterioration of the budget balance will be larger – from a *surplus* of 2.4 percent of the GDP in 2000 to a deficit of about 4 percent of GDP in 2004 (Chart III-1). The difference from the early 1980s would be even greater if it were adjusted for the effects of inflation on the real value of the public debt. Yet, the political reaction is still muted. The Administration at first argued that deficits were unimportant

Chart III-1  
Severe Deterioration in Budget Deficit



and had few bad effects; or, even if they had bad effects, there were higher priorities than deficit reduction. Their rhetoric has evolved a bit and Vice President Cheney recently referred to himself as a “deficit hawk,” but no significant deficit reducing actions have been proposed. A few Democrats would rescind Bush’s tax cuts entirely and a few more would rescind them only for the “rich,” but many of these would spend the money on expanding health insurance coverage and not on reducing the deficit.

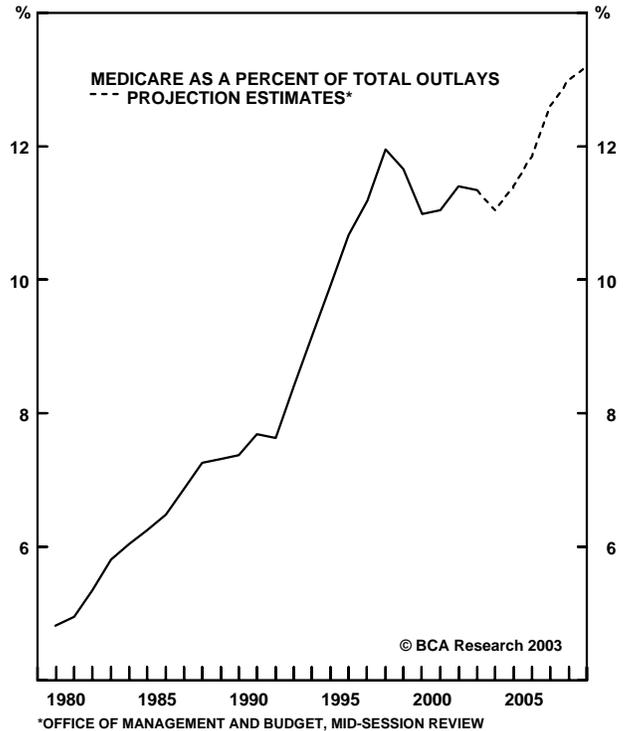
Discretionary domestic spending is likely to be more restrained than if there were no deficit – starving the beast works to some extent – but the main spending issues being debated involve adding an expensive prescription drug benefit to Medicare and spending an additional \$87 billion on Iraq and Afghanistan. There is no intent to finance the latter by anything other than borrowing, and any cost saving reforms in Medicare will simply be used to increase the generosity of benefits, given that an allowance of \$400 billion over 10 years for the net cost of the Medicare prescription drug program has already been put into the budget (Chart III-2).

**Reasons to Worry**

Clearly, fighting deficits is not as stylish as it was in the 1980s, and this is more than a little worrisome. Substantively, there are stronger reasons to be concerned today than in the 1980s. We knew in the 1980s that there would be a respite from demographic pressures on the budget in the following decade, because the relatively empty cohorts of Depression babies would be retiring in the 1990s.

The first baby boomer will apply for Social Security in 2007. That is the year that the contribution of the Social Security trust funds’ surplus to financing the rest of the government reaches a maximum relative to GDP. It will peak in dollar terms at about \$112 billion in 2008 and then begin a slow decline. Roughly 10 years later the Social Security system will become a drain on the rest of the budget, and the drain becomes a deluge in the 2020s. By the end of the 2020s, outlays for the combination of Social Security, Medicare and Medicaid will have risen by 6 percent of GDP compared with today’s level.

Chart III-2  
Medicare: A Growing Burden



If the political mood changes and the Congress wants to seriously attack the deficit, it will first find that it no longer has the procedural tools that were so helpful in the 1990s. The Budget Enforcement Act of 1990 (BEA) imposed caps on discretionary spending and created a pay-as-you-go rule that prevented tax and entitlement policies from increasing the deficit. The BEA began to be circumvented when a budget surplus emerged in 1998, and it was allowed to expire at the end of 2000.

The whole Congressional budget process created in 1974 is in sad shape. Although the spending targets embodied in budget resolutions were violated by large amounts in the early 1980s, the process helped to impose discipline later, especially after being enhanced by the BEA. After 2000, the spending targets embodied in annual Budget Resolutions were no longer supported by legal limits on discretionary and entitlement spending and were routinely ignored. Then September 11 provided an added excuse for large increases in defense and homeland security outlays without greatly dampening the enthusiasm for other domestic spending increases.

The budget process became something of a joke in the tax debate of 2003. The Senate imposed a \$350 billion limit on the 10-year cost of the 2003 tax cut, but the limit was then effectively evaded with a weird combination of phase-ins and sun-sets.

The most pessimistic political observers now believe that deficit reduction does not pay. They note that the first President Bush fashioned a huge bipartisan deficit reduction package together with the Congress and then lost the subsequent election. President Clinton put together a Democratic package almost as large relative to the size of the economy and then lost the Congress to the Republicans. The pessimists ask: "Who would try that again?"

Part of the problem today is that there is an excuse for deficits related to war, homeland security, and economic weakness. Current excuses will become less persuasive if the deficit persists in the face of an economic recovery and a decline in war-related expenditures. Nevertheless, there will still be formidable barriers to deficit reducing actions.

The most important involves the growing partisanship in the Congress and in the country as a whole. There has never been a wider disparity in the approval rating of a president between those who call themselves Democrats and those who call themselves Republicans. Liberals absolutely loathe President Bush while conservatives love him. It is impossible to imagine fashioning a bipartisan budget deal such as the one that emerged in 1990. If there is to be a deal, it will have to be put together by the majority party in the Congress and that most likely will continue to be the Republicans, most of whom are not now very interested in deficit reduction.

Later, I shall describe combinations of circumstances that might provoke a change in attitudes. Before that, it is necessary to explore a technical problem that could have important political ramifications.

### **The Impossibility of Forecasting the Budget Balance**

The rapid growth of the deficit, both in the early 1980s and in the 2000s, involved negative revenue surprises. Reagan's large tax cuts were designed,

in part, to offset the effects of inflation pushing people into higher tax brackets. When inflation was conquered faster than economists expected, the tax cuts became very real and very large. But the mechanism was understood and revenue forecasts, though never precise, became relatively accurate in the mid-1980s.

In 2001, revenues began a rapid descent relative to GDP that is only partly related to the tax cuts of 2001, 2002, and 2003 (Chart III-3). The decline followed a huge increase in the revenue-GDP ratio in the late 1990s – also unrelated to legislation. Both the rise and the descent of the revenue-GDP ratio caught revenue estimators by surprise. As a result, short-run forecasts of the budget balance have been almost worthless since 1997, first being much too pessimistic and then being much too optimistic.

The ups and downs of the revenue ratio are clearly related to the economic boom and subsequent collapse of the stock market bubble. With the collapse, capital gains tax revenues plummeted, stock options were no longer worth much, and the incomes of the very rich took a severe hit. The current situation leaves revenue estimators out at sea. Clearly, tax collections will be linked to the future course of the stock market, but revenue estimators, like so many others, are not very good at forecasting the stock market. Even if the market and the economy continue to recover nicely, it is not clear that the incomes of those in the highest tax brackets will do as well as in the late 1990s. We could be returning to the much more equal distribution of income prevalent in the 1970s – and a more equal distribution means lower revenues. In 2000, the top one percent of adjusted gross income earners were responsible for 37 percent of personal tax revenues.

The potential for error is enormous. In April of 2001, the Administration forecast a budget surplus of \$334 billion for 2003 (Chart III-4). A little more than two years later, in July of 2003, it forecast a deficit of \$455 billion – a change of \$789 billion! Legislated tax cuts in 2001, 2002, and 2003 were responsible for 23 percent or \$177 billion of the difference, while spending in excess of that anticipated – some related to September 11 – was responsible for 24 percent or \$193 billion. A full 53 percent or \$418 billion (3.9 percent of GDP) was due to "economic and technical re-estimates." Ultimately, an actual deficit of \$374 billion was

Chart III-3  
Revenue is More Volatile Now

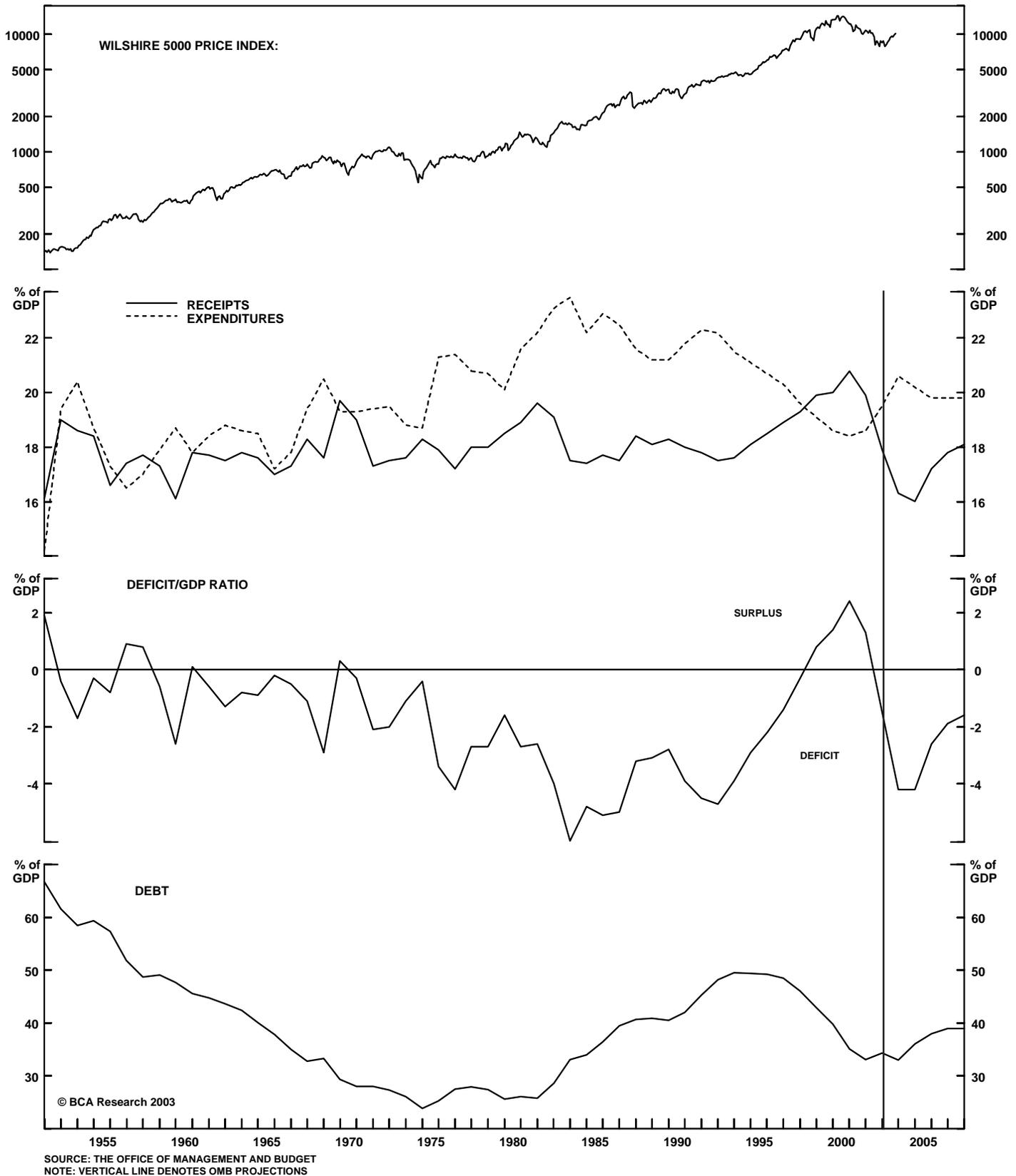
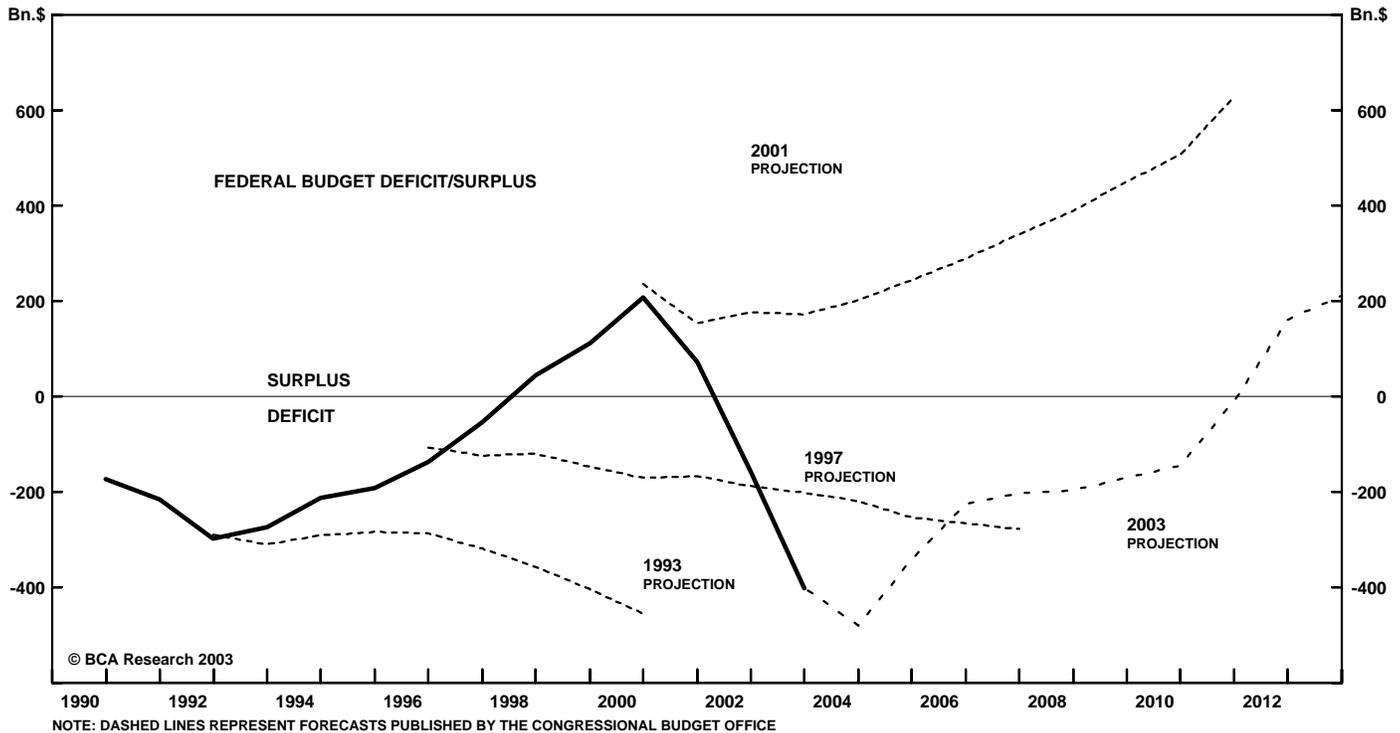


Chart III-4  
Accurate Deficit Projections are Increasingly Difficult



announced for 2003 – \$81 billion lower than the estimate made only three months earlier. If a similar mistake is now being made in our estimates for 2005, the actual outcome could range anywhere from a small surplus to a deficit that nears the post World War II record of 6 percent of GDP.

Before considering supplementals for Iraq and Afghanistan, the CBO had estimated the baseline deficit at 2.9 percent of GDP for 2005, whereas the Administration estimated it at 2.6 percent of GDP assuming presidential policies. Both estimates assume that the revenue-to-GDP ratio returns to a ‘normal’ level relative to past history. The Administration projects an increase in the ratio from a 54-year low of 16.0 percent in 2004 to 18.1 percent in 2007 and 2008 with its tax cuts extended. This is a guess, not a promise. Both estimates also assume that we shall do nothing to offset the rapidly increasing tax burden related to the alternative minimum tax.

Our inability to forecast the budget balance allows some lobbyists for further tax cuts to argue that the deficit problem may go away of its own accord. It may, but it also could get a great deal worse.

### Making the Deficit a Political Issue

What could change attitudes and again put us on a course toward deficit reduction? The most powerful political pressures for fiscal responsibility generally emanate from financial markets. James Carville, President Clinton’s political adviser, once remarked that if he was reincarnated, he would like to return as the bond market, because it is so politically potent. One does not observe strong pressures from the financial community yet, and such pressures may not appear without the emergence of an economic problem that people rightly or wrongly associate with fiscal policy. That could be a rapid rise in interest rates and inflation, or a dollar crisis.

The degree of pressure coming from financial markets will, of course, depend on budget outcomes. The current projections by the Administration are not that alarming. Indeed, they hold out the prospect of a declining debt-GDP ratio after 2005. As just noted, the problem could become alarming if revenue estimators are as overly optimistic as they have been in recent years. If revenue estimates were to stay at the 16.0 percent

Table III-1  
Budget Totals

	2002 Actual	Estimate					
		2003	2004	2005	2006	2007	2008
In billions of dollars:							
Receipts	1,853	1,756	1,797	2,033	2,215	2,360	2,480
Outlays	2,011	2,212	2,272	2,338	2,452	2,573	2,706
Deficit	-158	-455	-475	-304	-238	-213	-226
Gross Domestic Product (GDP)	10,337	10,746	11,266	11,829	12,413	13,024	13,671
As a percent of GDP:							
Receipts	17.9	16.3	16	17.2	17.8	18.1	18.1
Outlays	19.5	20.6	20.2	19.8	19.8	19.8	19.8
Deficit	-1.5	-4.2	-4.2	-2.6	-1.9	-1.6	-1.7

Source: Office of Management and Budget, Mid-Session Review

level projected for 2004, the deficit would rise above \$500 billion and would remain around 4 percent of GDP through 2008. Conversely, positive and negative revenue surprises tend to go in long streaks, and while one should not pin too much hope on the positive one-month revenue surprise that occurred in September, it offers a dim ray of sunshine (Table III-1).

If no pressure comes from the financial community, the next best hope is the old-fashioned, fiscally-responsible Republicans and moderate Democrats in Congress who tried without much success or persistence to limit the 2003 tax cut. Their influence will depend crucially on the outcome of the 2004 election. If President Bush wins big and retains a high level of popularity for a time, Congressional Republicans will not try to thwart him if he is happy to live with large deficits. When his popularity was extremely high after 9/11 and the Afghan and Iraq victories, we saw the U. S. system morph into a parliamentary democracy with the executive branch in control and with extreme party discipline.

If, on the other hand, the President wins with a tiny majority or is defeated, and if the Congress remains closely divided, the fiscally-responsible moderates in both parties are likely to hold the balance of power. We have already seen Republican party discipline decline with Bush's popularity rating. It will be difficult to fully extend the tax cuts without strong party discipline, even assuming that the Republicans retain the Congress. That will be especially true if the deficit does not decline substantially.

Without a strong political mandate, Bush's foreign policy is also likely to become less aggressive, and defense spending could quickly decline by 1 percent of GDP. Unlike others, I also think that neither the Administration nor the Congress will move quickly to relieve the rapidly growing burden associated with the minimum tax. This will foster substantial revenue growth relative to GDP. None of this will cause deficits to go away, however. We shall need a whole series of positive revenue surprises to do that.

## **The Economic Consequences of Current Fiscal Policy**

The most important effect of deficits is that they erode a nation's wealth either by crowding out domestic capital formation or by sucking in capital from abroad. If the latter occurs, there is a growing international debt that must be serviced in the future. Empirical evidence suggests that deficits can do this damage without provoking a very large rise in interest rates. To the extent that fiscal policy influences interest rates, it is probably through its effect on the debt-GDP ratio rather than through the ups and downs in deficits relative to GDP.

The deficit-GDP and debt-GDP ratios often move in opposite directions. For example, there are good reasons to hope for a decline in the deficit-GDP ratio in 2005, but the decline is unlikely to be sufficient to keep the debt-GDP ratio from growing. Academic studies estimate that equilibrium real bond yields rise by about 8 basis points for every 1-percentage-point rise in the debt-to-GDP ratio. Based on this estimate, the CBO's latest projection for the debt-to-GDP ratio implies a rise in the equilibrium real bond yield (i.e. fair value yields) of 50 basis points by 2005.

Thus, there are likely to be upward pressures on interest rates through 2005 unless official estimates are much too pessimistic or the Congress suddenly returns to the old-time religion of budget balancing. The total absence of any sign of the latter is a major reason to be much more concerned about deficits today than in the 1980s.

With the lagged effects of the 2003 tax cuts, and the supplemental appropriation for Iraq and Afghanistan, fiscal policy is likely to remain stimulative in 2004, although somewhat less than it was in the previous two years. I would expect the lagged effect of the tax cut and appropriations in 2003 to provide a fiscal thrust of about 1 percent of GDP next year, still a large stimulus by historical standards.

If current projections happen to be accurate for 2005, the deficit will decline absolutely by a large amount in that year. In the Administration projections, much of the decline will come from a large increase in the revenue-GDP ratio resulting from real growth pushing people into higher tax

brackets, an increase in revenues from the minimum tax, a restoration of the incomes of the very rich, an increase in capital gains revenues, and a substantial recovery in corporate tax revenues. Current definitions mean that the effects of changes in the distribution of income and capital gains will be considered by CBO analysts to decrease the cyclically-adjusted deficit, thus making it appear more restrictive than it really is.<sup>1</sup> Revenue gains resulting from capital gains and increased income for the rich may restrain an economic expansion, but they will not reverse it.

One wild card exists for 2005. The temporary enhancement of depreciation passed as part of the 2002 stimulus package is scheduled to expire in 2004. There will be intense lobbying to extend it and there are separate efforts to favor manufacturing. I do not think that these efforts will succeed, and if it becomes apparent that the investment incentive will end, there will be a very powerful incentive for firms to move business investment forward from 2005 to 2004.

## **Summary**

Although the recent deterioration of the budget balance is similar in magnitude to that which occurred in the early 1980s, the political response is very different. In the 1980s and early 1990s, the Congress worked vigorously to restore fiscal responsibility. There is little evidence of that occurring today and that makes the current situation much more worrisome than in the 1980s. Policy is unlikely to be reversed unless the financial community begins to agitate for deficit reduction or old-fashioned fiscal conservatives in the Congress gain power as a result of the 2004 elections. The former is unlikely to occur unless an economic problem emerges that is rightly or wrongly associated with the deficit.

Because budget forecasts have been of such low quality in recent years, it is difficult to assess exactly how much more serious the current situation is than in the 1980s. But we do know with

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1 The change in the cyclically-adjusted budget balance as a percent of GDP is often used as a measure of fiscal 'thrust' or stimulus.

certainty that a demographic crisis is looming over the next three decades and it would be preferable to enter that period with a healthier budget balance.

In the short run, the budget will continue to exert upward pressure on interest rates at least through 2005 unless current projections are far too pessimistic. Fiscal policy should remain expansionary through 2004, and although the deficit may decline abruptly in 2005, it is projected to do so mainly because of the various positive effects of the recovery on revenues and not because policy swings in a highly restrictive direction. Any move to restraint resulting from the 2004 election will occur after the 2005 budget is largely settled. An earlier move to restraint would have to be caused by a collapse of the dollar, a blowout in bond yields, or some other economic crisis.