Budget blues: the fiscal outlook and options for reform

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Abstract

Establishing a sustainable fiscal policy is central to the nation's long-term economic prospects, but requires a clear understanding of how past and current policies affect future resources. The federal budget should, but does not, provide this information, both because the task is difficult and current accounting practices are deficient. This paper shows that adjusting the official budget for many accounting and economic issues implies a bleak fiscal outlook that presents policymakers with difficult choices. We also explore options to restore fiscal sustainability directly and to improve the budget process that governs fiscal decisions.

The other chapters in this book focus on a particular area of public policy. Should society devote more resources to helping unskilled workers get job training? Should defense spending increase? Should we provide new tax subsidies for retirement saving? This chapter focuses on a broader, but in some sense more straightforward, question: Once all the individual components and policies are added together, is the government living within its means? Are the tax laws that legislators have enacted consistent with the spending programs they have created?

If tax and spending decisions only had implications for the current year, it would be straightforward to determine whether the government was living within its means—one could simply compare revenue and spending in that year. But the economic effects of past and current legislation play out over many years—even decades. As a result, decisionmakers and the public require a clear understanding of the claims that previously enacted laws and current decisions make on resources not only today but also in the future, and on whether laws currently in place commit the government to future taxes that equal, exceed, or fall short of future spending obligations. Indeed, it is difficult to see how intelligent fiscal policy could be made in the absence of such information.

Ideally, the federal budget would provide this information. In practice, it does not, at least partially because of the difficulty of the task itself. But even compared with what is feasible within a timely and understandable budget, current practice falls short of the desirable. First, the budget uses assumptions defining current tax and spending policy that are unrealistic. Second, official budget projections employ a ten-year horizon. Practical considerations make some limit necessary, as projections become more speculative as the horizon lengthens. But such a budget "window" excludes the fiscal effects associated with the aging of the baby boomers, most of which will occur well after the next ten years. Third, even within the ten-year budget window, budget projections are uncertain, in part because the economic events that affect the projections are difficult to predict accurately.

The upshot is that the official budget bears little relation to the underlying financial status of the federal government. A person asking if the government was living within its means—would hard-pressed to find the answer in current official budget projections.

But getting the answer right is important because a government living beyond its means can impose substantial costs on the economy. If revenues are not sufficient to match spending, the government must meet the shortfall by printing money or by borrowing. Sustained reliance on printing money to finance deficits can lead to escalating price inflation, which can have debilitating consequences. Sustained reliance on government borrowing leads to significant reductions in the domestic capital stock (to the extent that government borrowing draws financing away from private capital in the United States) or increased indebtedness to the rest of the world (to the extent that government borrowing draws financing from other countries). Regardless of how the government borrowing is financed. Americans' claims on future output would be reduced and future living standards harmed. As a result.
The government’s ability to run a sustainable fiscal policy, though, depends on the provision of appropriate information. More accurate budget figures would give policymakers and the public the best available information to guide policy choices. For example, when President George W. Bush came into office, the official projected ten-year surplus was $5.6 trillion—more than 4 percent of the economy—over the ensuing ten years. More realistic estimates, however, suggested that, even before considering the president’s tax cut, the ten-year surplus was only about $1 trillion and was substantially uncertain, and longer-term projections showed a significant fiscal shortfall. Nevertheless, the public debate that led to the $1.35 trillion tax cut in 2001 ignored the long-term figures and focused on the faulty, official ten-year projections. To be sure, some would argue that the tax cut was the right choice under any budget situation. At the very least, though, a more informative debate and a better-informed decision would have occurred if policymakers and the public had focused on more realistic budget figures.

The difference between the official budget estimates and more reasonable projections are even more striking today, in part because the 2001 tax cut exacerbated the bias in the official numbers. Indeed, the impact of more realistic spending and tax assumptions has become large enough to convert a forecast ten-year surplus of $1.3 trillion into a deficit of more than $4.5 trillion. The resulting deficit amounts to more than 3 percent of the economy and about 16 percent of federal revenues during the next ten years.

Using longer time horizons, the budget picture is even bleaker. Although the government provides no regular budget estimates beyond a ten-year horizon, spending on Social Security, Medicare, and Medicaid is almost certain to grow faster than national income or revenues as the baby boom generation retires, life spans lengthen, and per capita health care expenditures rise. We estimate that federal revenues are likely to fall short of federal spending by 4 to 8 percent of GDP in the long run. That is, it would require an increase in federal revenues of about 21-39 percent, a comparable decline in spending, or some combination of the two, to bring the long-term budget into balance. These projections, even more than the ten-year forecasts, are subject to error, but a large shortfall is probably a safe bet even after taking the relevant uncertainties into account.

The resulting budget outlook—bad over the next decade and worse in future years—presents policymakers with difficult choices. There are only three ways to close the fiscal gap: encouraging economic growth, which makes the costs of federal spending more affordable; raising tax revenues; or reducing spending. The first way is easy to embrace but hard to achieve. The second and third are politically difficult: Tax increases and spending cuts are not popular, however necessary they may be.

Given the uncertainty inherent in the long-term estimates—which implies the possibility that large long-term deficits might not materialize—and the daunting economic and political risks associated with large-scale tax increases and spending cuts, elected officials have so far chosen not only to ignore the long-term problems but also to make them worse by enacting substantial tax cuts and spending increases in recent years.

We believe that increasing the fiscal gap is a significant policy error and that actions to reduce the gap should come sooner rather than later. We present estimates of the extent to which alternative tax and spending policies would close the fiscal gap. Moreover, because the actions needed are politically difficult, we also examine changes in budget rules that could nudge elected officials toward responsible behavior. Although it is possible to make the budget process more conducive to long-term fiscal discipline, in the end there is no substitute for making painful choices.

Note: This report is available in its entirety in the Portable Document Format (PDF).

1. Theoretically, the government could also sell some of its assets to finance an imbalance between revenue and expenditure. (In the federal budget, asset sales are misleadingly classified as spending reductions rather than as a source of financing for a deficit, so they reduce the measured deficit rather than provide a means of financing it.)

2. It can also have an effect on the economy’s short-run performance, if increased government borrowing raises interest rates, and hence makes investment more costly. See William Gale and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center Discussion Paper 8 (April 2003).


About the Authors


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INTERNATIONAL MONETARY FUND Fiscal Affairs Department. A Fiscal Indicator for Assessing First and Second Pillar Pension Reforms1 Prepared by Mauricio Soto, Benedict Clements, and Frank Eich Authorizd for distribution by Carlo Cottarelli April 12, 2011. DISCLAIMER: This Staff Discussion Note represents the views of the authors and does not necessarily represent IMF views or IMF policy. William G. Gale, Peter R. Orszag, and Samara Potter, 2003, “Budget Blues: The Fiscal Outlook and Options for Reform,” Agenda for the Nation, ed. by Henry Aaron, James Lindsay, and Pietro Nivola (Washington: Brookings Institution), Chapter 1: Budget Reform and Medium Term Fiscal Policy. On Budget Day, Parliament is presented with a set of three-year spending plans, but is only asked to vote on the budget for the coming year. The three-year spending projections allow Parliament, institutions of civil society and particular interest groups to evaluate Government’s reconstruction and development goals and objectives in relation to envisaged spending plans. While the vigour of public debate will no doubt remain undiminished, its substance and quality are enhanced by the transparency and extent of information Government provi