Fiscal Imbalance in the United States: Where Do We Stand?

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INTRODUCTION

We begin by noting that while the recent fiscal troubles in Greece have received much attention, the U.S. fiscal position is hardly comparable to that of Greece. The United States is the world’s largest economy and can absorb large economic shocks much more easily than Greece. In addition, the U.S. dollar is currently the world’s reserve currency and thus is perceived as a safe store of value in times of economic distress abroad. The United States also benefits from having its own currency because it can use monetary policy to offset economic downturns and to pay off debt if needed (although there are often serious consequences to simply printing money to pay debt).

By comparison, Greece does not control its monetary policy and is instead dependent on the European Central Bank, which must coordinate monetary policy for all the members of the EU. In this respect, Greece is similar to a U.S. state, so that a comparison of Greece to relatively small U.S. states with relatively large underfunded and unsustainable pension obligations and other benefits for public sector workers would be a relevant comparison. Finally, Greece’s budget deficits required a relatively large fiscal adjustment partly due to persistent declines in GDP over the last several years. However, while Greece and the United States face drastically different scenarios, the United States is experiencing, and will continue to experience, one of the fundamental economic costs of relatively large and persistent deficits, as the cost of servicing an increasing debt requires a reduction in other government spending to avoid increases in deficit spending. This cost can be reined in only with systematic tax and expenditure policy reforms that will put the United States back on a sustainable fiscal path.

Much attention has been paid in recent years to the long-run fiscal problems facing the United States. The chief arbiter in these discussions is the nonpartisan Congressional Budget Office (CBO), whose primary purpose is to provide Congress with a baseline projection of the future fiscal implications of currently legislated tax and expenditure policies. This current law baseline provides policymakers with a starting point to examine how alternative policy changes would affect the U.S. budget. It is important to note that CBO’s current law projections are fundamentally different from a budget forecast, that is, an estimate of the budgetary effects of the actual policies that might be adopted over the budget window; instead, the projections simply assume that the provisions of current law continue without change. But CBO

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also recognizes that many policy changes, including extensions of “temporary” taxes and expenditure provisions that are currently scheduled to expire but have often been renewed in the past, are likely to occur. Accordingly, CBO also provides estimates of the budget effects of an alternative current policy scenario—which is defined as current law adjusted for policy changes that are likely to occur in the budget window—and is thus much closer to a budget forecast. Of course, one of the major hurdles in accurately forecasting budget outcomes is predicting which policies will, in fact, be enacted. In addition, there are several other major hurdles to accurately forecasting budget outcomes, including estimating the macroeconomic effects of the newly adopted policies and predicting the path of economic variables that have significant effects on budget outcomes, such as interest rates, growth in the cost of entitlement programs—especially Social Security and various health care programs—changes in market conditions, and the reactions to U.S. policy changes of foreign governments and central banks. In this Baker Institute issue brief, we discuss these aspects of budgetary estimates to better understand the dimensions of the long-run fiscal policy problems confronting the United States.

CURRENT CBO ESTIMATES

CBO’s (2015a) current projections show the annual budget deficit in the United States shrinking from 2.7 percent of GDP in 2015 to 2.5 percent in 2017, a level that is below the average deficit from 1965 to 2014 (the prior 40-year average) of 2.7 percent of GDP. The structural fiscal problems in the United States arise in the “out years,” as CBO’s projections show that after 2017 deficits begin to grow significantly, reaching 3 percent of GDP by 2019 and 4 percent of GDP by 2025. From 1965 to 2014, average outlays were 20.1 percent of GDP and average revenues were 17.4 percent of GDP. CBO projects that revenue as a share of GDP will increase from 17.7 percent in 2015 to 18.3 percent in 2025, 0.9 percent of GDP above the 40-year average. (Note, however, that a large fraction of this increase is uncertain as it is attributable to the expiration of provisions that have been routinely extended in the past, a practice that seems likely to continue in the future.) Outlays are projected to increase from 20.5 percent of GDP in 2015 to 22.2 percent in 2025, 2.2 percent of GDP above the 40-year average. This increase is primarily related to an increase in spending on the increasing fraction of the population that is elderly, including benefits under the Social Security and Medicare systems, expenditures on other publicly funded health care programs, and on interest payments on the growing level of debt. Clearly, increasing deficits are being driven by rising outlays in spite of a rise in revenues as a share of GDP in the current projections. Over this period, debt held by the public is projected to fall initially from 74 percent of GDP in 2015 to 73 percent of GDP in 2018, before increasing to 78 percent of GDP in 2025—and to 103 percent of GDP by 2040.

The overall change in revenue can be broken down into changes in personal income taxes, payroll taxes, corporate income taxes, and other taxes and fees. From 2015 to 2025, personal income taxes are projected to increase by 1.1 percent of GDP, corporate income taxes are projected to remain unchanged, payroll taxes are projected to decrease by 0.2 percent of GDP, and other sources of revenue are projected to decrease by 0.5 percent of GDP. The allocation of spending is also projected to undergo some fundamental changes, with increases in spending on Social Security, health care, and net interest dominating the landscape. From 2015 to 2025, mandatory spending is projected to increase by 1.4 percent of GDP (from 12.7 percent to 14.1 percent of GDP), with a 0.8 percent of GDP increase in Social Security, a 0.9 percent increase in spending on the major health care programs, and a 0.3 percent decline in other mandatory programs. By comparison, discretionary spending is projected to fall by 1.4 percent of GDP (from 6.5 to 5.1 percent of GDP).
of GDP). Finally, net interest is projected to increase by 1.7 percent of GDP (from 1.3 to 3.0 percent of GDP). These trends are projected to continue in the long term.

THE LEVEL OF DEBT AND RECENT AND FUTURE POLICIES

During the Great Recession and the years immediately following, from 2009 to 2012, the annual U.S. deficit was over $1 trillion dollars and ranged from 6.5 percent to 9.2 percent of GDP. Over this period the debt-to-GDP ratio increased from 39.3 percent in 2008 to 70.1 percent by the end of 2012. As the U.S. economy recovered in the years following the Great Recession, albeit slowly and in fits and starts, reducing the deficit was a primary policy concern of some policymakers, while other policymakers argued for continued increases in spending to provide additional support for a tepid economic recovery.

Disagreements on the proper path for U.S. fiscal policy led to the debt-ceiling crisis of 2011 in which the U.S. teetered on the brink of sovereign default. However, on August 2, 2011, the Budget Control Act (BCA) of 2011 was signed into law, effectively ending the threat of default. The BCA allowed the debt limit to increase by as much as $2.1 trillion to $2.4 trillion and outlined $917 billion in reductions in budget authority over 10 years. In addition, the BCA created the Joint Select Committee on Deficit Reduction (also known as the “Super Committee”) and tasked it with finding an additional $1.5 trillion in deficit reduction over the 10-year budget window by December 2011. If the Super Committee was unable to agree on a deficit reduction package, then $1.2 trillion in budget cuts (known as sequestration) would be implemented. Given the failure of the Super Committee to enact a deficit reduction package, the BCA requires $109 billion in cuts for each year (split equally across defense and non-defense spending, with exemptions for certain programs including Social Security, Medicaid, federal pensions, and veteran’s benefits) from the budget authority caps, which include the initial $917 billion in reductions.

However, other legislation has modified the BCA. For example, the fiscal cliff deal (the fiscal cliff was created by the expiration of the Bush tax cuts and the onset of the BCA spending cuts) resulted in The American Taxpayer Relief Act (ATRA) of 2012. ATRA reduced projected revenues by $3.6 trillion from 2013–2022 (which included tax cuts for those making less than $250,000 and a substantial increase for those earning above $250,000) and additional $0.3 trillion in spending from 2013–2022, increasing the cumulative deficits from 2013–2022 by $3.9 trillion. It also delayed the spending cuts due to the failure of the Super Committee to enact a deficit reduction package. More recently, the Bipartisan Budget Act (BBA) of 2013 increased the BCA spending caps in 2014 and 2015 and extended the spending caps in the BCA to 2022 and 2023.

An important factor affecting the growth in the U.S. debt is whether Congress and the administration will allow the full imposition of sequestration to continue in 2016 and the years that follow. The president’s budget for 2016 proposes to reduce the sequestration cuts by about $75 billion (that is, the budget proposes to increase spending above the spending limits), split equally across defense and non-defense spending. The administration also proposes an additional $51 billion for overseas contingency operations that are treated as emergency funding. It is yet to be determined if Congress will override the BCA budget cuts that resulted from the failure of the Super Committee to agree on deficit reduction measures—a critical factor because these cuts are currently included in the CBO “current law” deficit baseline projections. This implies that relaxing these budget cuts will increase projected deficits unless they are offset by other spending cuts or tax increases. Similarly, as discussed above, a number of tax provisions that are regularly extended (such as the research and experimentation tax credit) are treated as if they will expire under CBO budget rules.

Under CBO’s alternative fiscal scenario (based largely on current policy), which some view as a more likely outcome, the national debt is projected to reach 175 percent of GDP by 2040.
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If these policies are extended, then deficits will be larger than currently projected. CBO (2015b) projects that under the extended baseline (based largely on current law), revenues will be 19.4 percent of GDP while spending will increase to 25.3 percent of GDP by 2040. This implies that in 2040, the deficit would equal 5.9 percent of GDP and the federal debt held by the public would be 103 percent of GDP. CBO also estimates that including the macroeconomic effects of higher marginal tax rates, larger deficits, larger transfer payments, and increased federal investment would increase the projected deficit to 6.6 percent of GDP in 2040. Note that under CBO’s alternative fiscal scenario (based largely on current policy), which some view as a more likely outcome, the national debt is projected to reach 175 percent of GDP by 2040.

Economic variables are also important in determining the projections provided by CBO. For example, CBO reports that if interest rates were 0.75 percent higher than in the baseline projections, federal debt held by the public would be 130 percent of GDP rather than 107 percent. If productivity growth were reduced by 0.5 percentage points relative to the baseline, then federal debt held by the public would be 125 percent of GDP rather than 107 percent. By comparison, if the rate of productivity grew by 0.5 percentage points more, the debt would fall to 91 percent of GDP, highlighting the importance of understanding the determinants of productivity growth, including those that can be affected by public policy.

One of the most important trends affecting the U.S. fiscal situation, especially in the Medicare program, is the recent slowdown in the growth of health care costs. For example, CBO projects the cost of Medicare spending per beneficiary will increase by 1.2 percent per year from 2015 to 2025; by comparison, Medicare spending per beneficiary averaged 4 percent from 1985 to 2007, excluding the effects of expanded prescription drug coverage enacted in 2006. This slower growth is predicted to result from a change in the composition of the pool of those covered, slower growth in health care costs (CBO states the reasons for this slowdown are “not yet entirely clear” but suggest some possibilities discussed below), and, at the time of the writing of the latest CBO report, constraints on the payment rates to physicians.

The recent influx of younger beneficiaries into the Medicare program as the baby boomers turn 65 reduces the average beneficiary age and thus reduces the cost per beneficiary within the 10–year budget window; however, in later years this shift in the beneficiary population is predicted to increase the cost per beneficiary as the average age of beneficiaries rises. CBO notes that the recent decline in health care costs has been attributed to various factors, including changes in the delivery and financing of health care, new state controls on Medicaid costs, and less rapid diffusion of new technologies—as well as to the effects of the Great Recession in limiting demand. The fiscal situation in the U.S. would deteriorate if health care costs were to rise again, while a continued decline in the growth of health care costs could greatly help the United States attain a sustainable fiscal policy. Note that the constraint on payment rates to physicians was repealed on April 16, 2015, and thus will increase the baseline budget deficit by about $140 billion relative to CBO’s January 2015 report on the budget and economic outlook.

ECONOMIC GROWTH AND DEBT

It is also important to examine how policies that encourage economic growth could help alleviate the problems of long-term fiscal unsustainability. For example, Diamond and Zodrow (DZ) (2014) examine the dynamic effects of a variant of TRA of 2014 proposed by then House Ways and Means Committee Chair Dave Camp. DZ find that TRA 2014 would increase GDP by 1.2 percent after five years, by 2.2 percent after 10 years, and by 3.1 percent in the long run. The long-run increase in GDP is primarily driven by a 5.0 percent increase in investment, a 1.0 percent increase in consumption, and a 0.2 percent increase in government purchases.
percent increase in the capital stock and a 0.3 percent increase labor supply, driven by significant reductions in corporate income tax rates, which in turn raise revenues in part by reversing income shifting abroad by U.S. multinational companies. Such an increase in GDP, which is simulated under a revenue neutral fiscal policy, would lower the debt to GDP ratio, as growing income makes it easier to service a given level of debt. Thus, it is important to examine how fiscal policy changes affect the growth rate of the economy—often referred to as dynamic analysis of fiscal policy.

Note that although it is controversial, dynamic analysis is already used on a fairly wide scale. For example, the Joint Committee on Taxation (JCT) has produced dynamic analyses of several significant tax proposals (JCT 2003; JCT 2005; JCT 2006; JCT 2014a; JCT 2014b). In addition, the Department of the Treasury’s Office of Tax Analysis (OTA) has published dynamic analyses of the reform proposals made by the President’s Advisory Panel on Federal Tax Reform (Carroll, Diamond, Johnson, and Mackie 2006) and the proposal to permanently extend the president’s tax relief (OTA 2006). The Congressional Budget Office also publishes macroeconomic analyses of various proposals, including the president’s budget (CBO 2003a and 2003b). And most recently, CBO (2015c) examined the budget and economic growth effects that would be related to repealing the Affordable Care Act, reporting that “CBO and JCT estimate that, over the final five years of the current budget window—the period from 2021 to 2025—repealing ACA would boost GDP by about 0.7 percent, on average, relative to current law projections.” The use of dynamic analysis is growing in importance and, if used properly, could facilitate the adoption of policies that will increase economic growth and improve U.S. fiscal sustainability.

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