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The inescapable conclusion is that we face a daunting fiscal situation, one with potentially harmful implications for the U.S. economy.

Fiscal Fitness: The U.S. Budget Deficit's Uncertain Prospects

by Jason L. Saving

Recent headlines tell us U.S. budget deficits have been shrinking in the past few years, but Washington's fiscal fitness remains a matter of concern.

The International Monetary Fund, for example, has argued that worldwide economic growth will be noticeably weaker in the future if the U.S. doesn't get its fiscal house in order. In January, Federal Reserve Board Chairman Ben Bernanke told Congress that the U.S. faces an impending fiscal crisis if it fails to address key budget issues.¹

Such warnings call for a sober examination of prospects for the nation's budget deficits. The most recent proposal envisions eliminating them within six years, but doing so will require lawmakers to overcome several significant obstacles. Other uncertainties emerge from the recently approved pay-as-you-go, or paygo, rules and their effect on potential reforms of the alternative minimum

tax (AMT). Both paygo and the AMT play important roles in another major fiscal question—the fate of the 2001 and 2003 tax cuts. Even if we manage to handle these short-term issues, the long-term challenge posed by entitlements is significantly greater, with no easy solutions in sight.

The inescapable conclusion is that we face a daunting fiscal situation, one with potentially harmful implications for the U.S. economy.

Spending Growth

The federal deficit has fallen for three straight years—from a record \$412 billion in 2004 to \$248 billion in 2006. In February, President Bush released a proposed budget under which red ink would decline to \$244 billion this year and \$187 billion in 2009. The document projects a surplus of \$61 billion in 2012 (*Chart 1*).

What assumptions underlie these figures—and are they likely to hold? The proposed budget assumes 3 percent real annual growth in gross domestic product (GDP) and 4.8 percent unemployment between now and 2012, figures that aren't out of line with most forecasts. But it also assumes that real spending growth will be held to 0.4 percent a year, very low by historical standards.

Past budgets have been presented with similarly inspiring calls to rein in government spending. If this year's targets were to be similarly disregarded, what might the deficit picture look like? To answer this question, let's look at the average annual increase in real federal outlays under the past few administrations (*Chart 2*).

Real outlays have grown at a 4.6 percent annual rate since President Bush took office in 2001, compared with 2.7 percent under Ronald Reagan and 0.8 percent under Bill Clinton. To some extent, the faster spending growth is

Chart 1

Will Deficit Turn to Surplus by 2012?

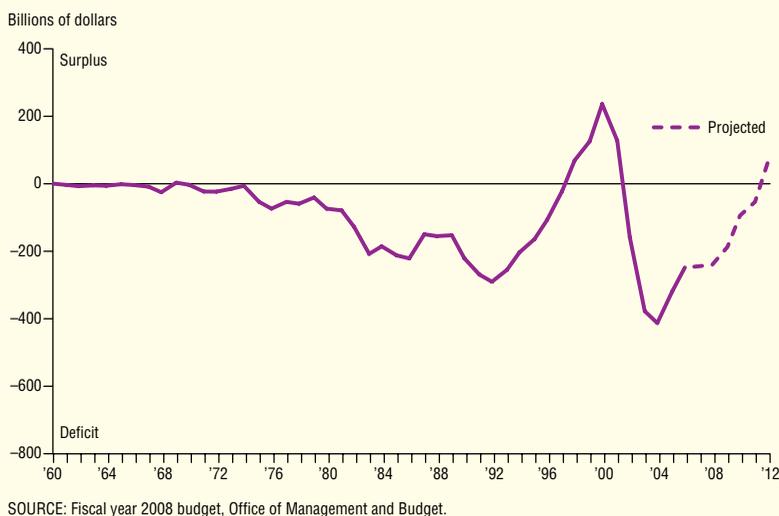
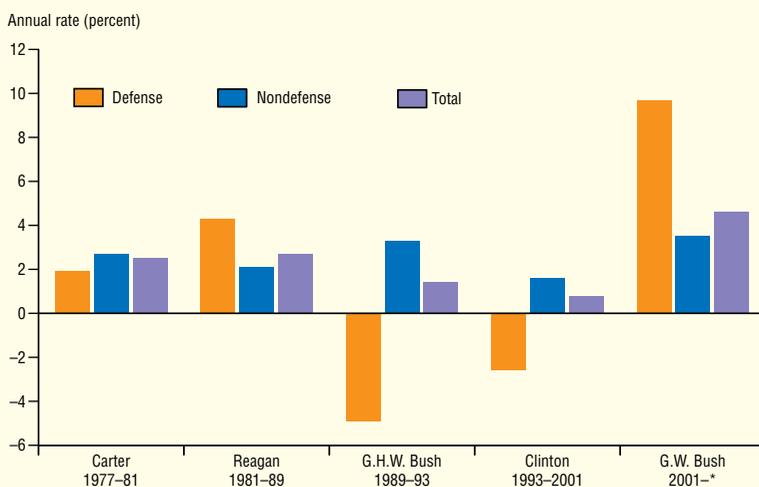


Chart 2

Spending Growth Has Accelerated





expected, given that we are now using the post-Cold War “peace dividend” to fight the war on terrorism. Defense spending has indeed been sharply higher in recent years, but nondefense outlays have also risen more rapidly, growing at a real annual rate of 3.5 percent.

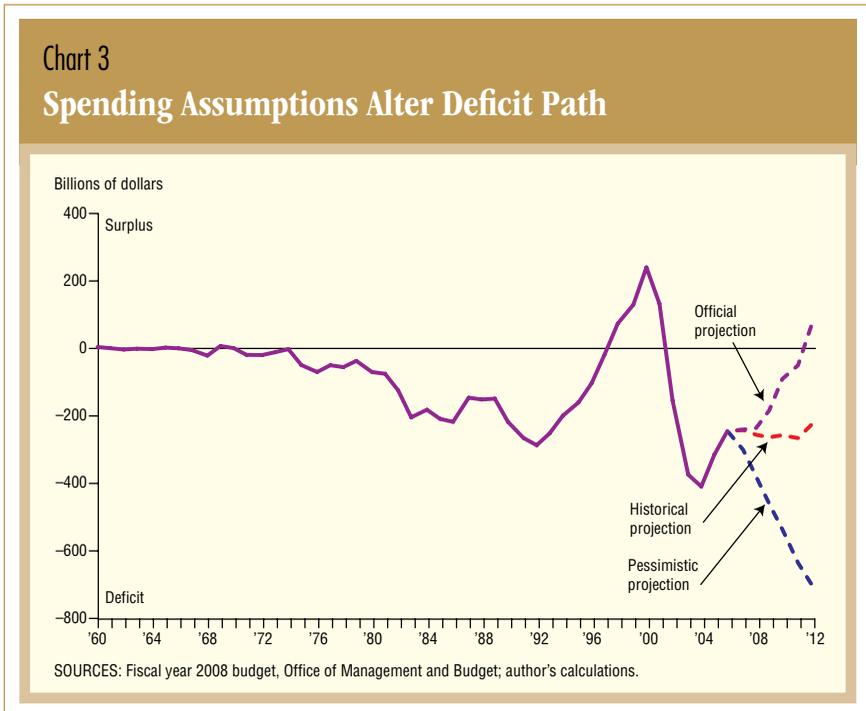
History creates doubts about whether Washington can limit spending growth to 0.4 percent a year, suggesting that the deficit picture may be worse in 2012 than the budget projects. How much worse? If one replaces the Bush administration’s spending growth assumption with the 4.6 percent rate that has thus far prevailed in the 21st century, the \$61 billion surplus turns into a \$701 billion deficit (*Chart 3*).

Let’s call this scenario the pessimistic projection because it assumes that the rapid post-9/11 defense buildup will continue. If it doesn’t, real annual spending growth between now and 2012 may more closely resemble its post-Vietnam War historical average of 2.3 percent a year. In this case, the 2012 deficit would be \$231 billion—about as large as today’s deficit.

Under the Bush administration’s proposed scenario, the U.S. won’t achieve a balanced budget unless spending growth is held far below recent trends. The paygo procedure, which a bipartisan House majority adopted in January, may help. In simple terms, the rule mandates that any entitlement increases or tax decreases be offset by new revenue.

A similar requirement was in effect when deficits disappeared in the 1990s. Several factors contributed to swinging the budget into surplus, but social scientists who have studied the issue conclude that the paygo rule’s influence on spending growth was significant.²

The paygo rule under which the House will operate isn’t as



strict as meets the eye. It requires budgetary neutrality over six-year and 11-year windows, which means that large spending in the near term could conceivably be offset by promised savings in the future. The rule doesn’t apply to tax and entitlement changes already signed into law. The rule can be waived when a majority wishes to do so.

However, most observers are discounting the possibility of major tax cuts or spending increases in an era of divided government. So fiscal policy may look as if it’s restrained by a binding paygo arrangement over the next few years, even if the actual rule is somewhat less stringent.

AMT Tax Relief

Paygo poses problems for fiscal reforms that would drain the federal Treasury. In particular, it may complicate efforts to reduce the AMT’s bite.

Originally designed to affect 155 households whose incomes exceeded \$1.1 million a year in today’s dollars, the AMT now ap-

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plies to 120,000 households in that income category—and an additional 3.4 million of lesser means. If no action is taken, the total number of households hit by the AMT will rise to 23.4 million this year—about a fifth of the nation’s total. The AMT rolls will swell to 52.6 million in 2017 (*Chart 4*).³

The rise in households paying the AMT promises to create a windfall for the Treasury. AMT receipts totaled \$23.9 billion last year; they will rise to \$69.8 billion in 2007 and \$265.2 billion in 2017 under current law.

Why is this happening? AMT brackets aren’t indexed for economic growth or inflation. So as per capita GDP and price levels have risen, the AMT has extended its reach from the wealthiest segment of the population into middle—or at least upper-middle—America.

A succession of temporary patches had held the inflation component at bay in recent years, but their expiration caused this year’s 20 million jump in AMT households.

While it’s often difficult to find consensus on fiscal issues, policy-makers generally agree that AMT brackets should be reset to their 2006 levels and then permanently indexed to inflation. Such a change would substantially slow the inexorable march of millions of households toward the AMT.

But it would be hugely expensive. Reform would reduce projected AMT revenue by an estimated \$945 billion over the next 10 years, assuming the 2001/2003 tax cuts are made permanent.

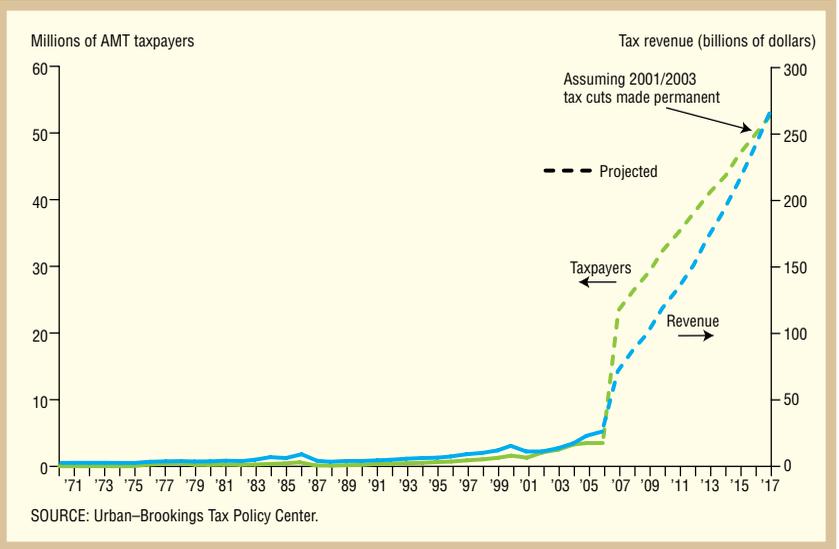
How can AMT reform be undertaken in a paygo policy environment? To answer this question, it’s necessary to examine the interaction between the 2001/2003 tax cuts and the AMT. Individuals pay the AMT only when their ordinary income tax liability falls below their AMT liability. Income tax rate reductions without corresponding cuts in the AMT inevitably swell the ranks of AMT taxpayers, effectively raising the cost of AMT reform.

If the 2001/2003 tax cuts are allowed to expire at the end of

The prospect of enlarging already big budget deficits stands in the way of AMT reform. Scaling back the 2001/2003 tax cuts would decrease the cost of AMT restructuring.

Chart 4

Alternative Minimum Tax Explodes in 2007 and Beyond





2010, as current law stipulates, the cost of long-term AMT reform would fall from \$945 billion to a more manageable \$520 billion.⁴

The prospect of enlarging already big budget deficits stands in the way of AMT reform. Scaling back the 2001/2003 tax cuts would decrease the cost of AMT restructuring and give Congress more flexibility under paygo. However, the size of the decrease would depend heavily upon which cuts stay and which go.

Taxes and Growth

The fate of the 2001/2003 tax cuts will likely be among the most hotly debated fiscal issues of the next few years.

We can now say with reasonable certainty that the tax cuts, which were highly controversial when adopted, provided a fairly modest economic tailwind at a significant cost—about \$240 billion a year in forgone revenue.

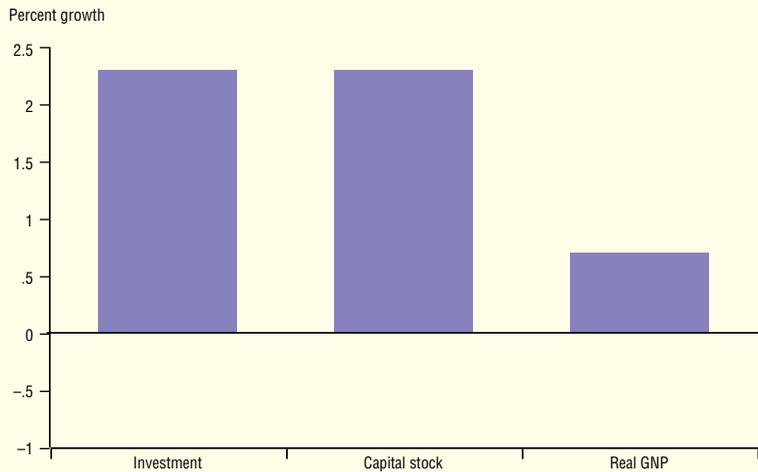
The Treasury Department examined the projected economic impact after 2010 if the tax cuts were made permanent.⁵ It found that investment and capital stock such as plants and equipment would both increase 2.3 percent in the long run. Permanent cuts would induce a 0.7 percent rise in gross national product (GNP)—a modest increase in the size of the U.S. economy (*Chart 5*).

But not all components of the 2001/2003 tax cuts are created equal (*Chart 6*). The dividend and capital-gains rate reductions would boost investment about 1.5 percent, the capital stock about 1 percent and GNP 0.4 percent. The marginal-rate reductions would also raise investment and the capital stock about 1 percent and boost GNP 0.7 percent.

The remaining components—primarily marriage penalty relief and expanded child tax credits—would reduce economic activity by

Chart 5

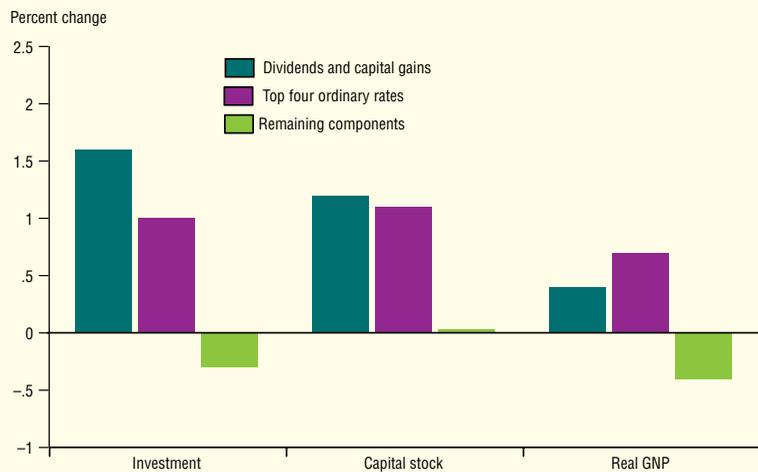
Tax Cuts Boost Economic Activity



NOTE: Data reflect projections from 2011 forward if tax cuts are made permanent.
SOURCE: Department of the Treasury.

Chart 6

Tax Cut Components Have Different Economic Impacts



NOTE: Data reflect projections from 2011 forward if tax cuts are made permanent.
SOURCE: Department of the Treasury.



modest amounts. Because they're the most popular elements of the 2001/2003 tax cuts, however, these components would be the most likely to survive in the current political climate.

The real danger isn't that the wholesale expiration of the 2001/2003 tax cuts might drive the economy into recession. Their aggregate effect is simply too small for that, even if full repeal were politically feasible. Rather, the danger is that partial repeal could leave us with much of the revenue loss but none of the tailwinds—or perhaps even with a slight headwind.

The Biggest Challenge

At least in the short term, the budget outlook is roughly what it has been in the recent past. The deficit will neither balloon nor vanish, and the complex interplay among near-term fiscal issues such as AMT relief and the 2001/2003 tax cuts poses challenges we can likely—or at least conceivably—weather.

The long-term outlook is more problematic, and the single greatest obstacle is entitlements. The infinite-horizon discounted present value of unfunded liabilities from Social Security and Medicare—the gap between what we take in and what we've promised to pay—is now \$88.2 trillion. That's six times the nation's GDP.

The potent combination of lower birthrates, higher medical costs and longer life expectancies provides little reason for thinking the situation will improve.

We can break down the \$88.2 trillion into its four primary components (*Chart 7*). The funding gap for Social Security, which President Bush and Congress have been wrestling with the past few years, represents the smallest part of the problem. The unfunded liability for Medicare Part D alone—

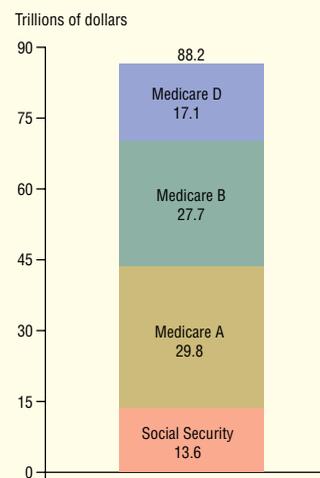
the drug benefit that took effect in January 2006—is greater than the entire Social Security shortfall.

Just how big is this unfunded liability on a per-person basis? Dividing the \$88.2 trillion evenly among the 300 million people who live in the United States produces a per-person liability of about \$290,000—more than five times the average household's annual income. That's what each U.S. resident would have to pay today to guarantee the solvency of Social Security and Medicare for future generations.

This is obviously not going to happen. Suppose we don't act now to reduce the shortfall but instead use general government revenue to pay all promised benefits. Just how much of a burden would this pose for future taxpayers? Social Security and Medicare currently consume about 4 percent of general revenue (*Chart 8*). By 2030, we would need to devote 34.2 percent of general revenue to entitlements. By 2080, the figure rises to 64.8 percent.

The unfunded liability for Medicare Part D alone—the drug benefit that took effect in January 2006—is greater than the entire Social Security shortfall.

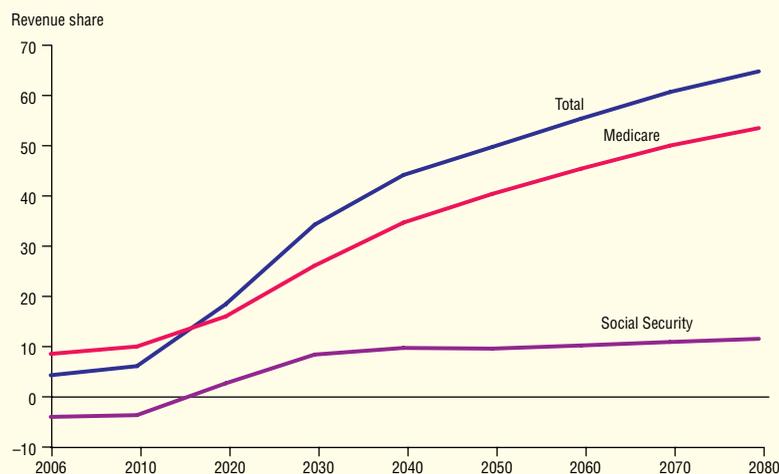
Chart 7
Medicare Dominates Unfunded Liabilities



SOURCES: Social Security and Medicare Trustees Reports.

Chart 8

Entitlements Expected to Consume More of U.S. Revenue



SOURCES: Fiscal year 2008 budget, Office of Management and Budget; Social Security and Medicare Trustees Reports; Private Enterprise Research Center; author's calculations.

Every other government function—from defense to environmental protection and education—would have to shrink dramatically to fit into the remainder.

A drastic, across-the-board reordering of government priorities doesn't seem likely. To the extent people think about the unfunded liabilities at all, they assume we will eventually address the issue by spending less or raising new revenue. After all, that's how any one of us would resolve a shortfall in our personal finances. But either approach is likely to reduce the economy's growth rate.

The government has an additional resource unavailable to ordinary citizens: the Bureau of Engraving and Printing. And as policymakers debate the huge spending cuts or tax increases that will be needed to restore the solvency of the entitlement system, can we be sure they won't come to view inflation as the least painful alternative?

Any long-term solution to the entitlement quandary will require

dramatic action, and the necessary response will be ever more drastic the longer it's postponed.

If past is prologue, policymakers will forgo the opportunity to fundamentally reshape the U.S. entitlement system and will instead adjust the parameters of the current system, as the Greenspan Commission did in 1983.⁶ Likely proposals are a higher retirement age, a lower cost-of-living adjustment and a more progressive payroll tax that could include elimination of the earnings cap.

While any of these measures would begin to address the unfunded liability issue, they have very different implications for future economic growth. For example, a higher retirement age would be expected to boost labor-force participation and thereby raise GDP growth. This has occurred in Europe over the past few years. However, some studies suggest that more progressive payroll taxes would reduce labor-force participation and thereby lower GDP growth.

As we grapple with avenues through which fiscal incontinence can be purged from the entitlement system, we must be ever mindful that some of these avenues will be more harmful to the economy than others.

Will policymakers rise to the occasion or leave the nation to face a future in which global output growth slows, pressure mounts to monetize the federal debt and younger generations inherit an unconscionable shortfall?

Which path will we take?

Saving is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

¹ "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," International Monetary Fund paper, January 2004; and "Long-Term Fiscal Challenges Facing the United States," testimony by Ben S. Bernanke before the Committee on the Budget, U.S. Senate, January 18, 2007.

² See, for example, "The Budget and Economic Outlook: Fiscal Years 2004–2013," Appendix A, Congressional Budget Office, January 2003.

³ "The Looming Challenge of the Alternative Minimum Tax," by Alan D. Viard, Federal Reserve Bank of Dallas *Economic Letter*, August 2006; and "The Individual Alternative Minimum Tax: Historical Data and Projections," by Greg Leiserson and Jeffrey Rohaly, Urban–Brookings Tax Policy Center, November 2006.

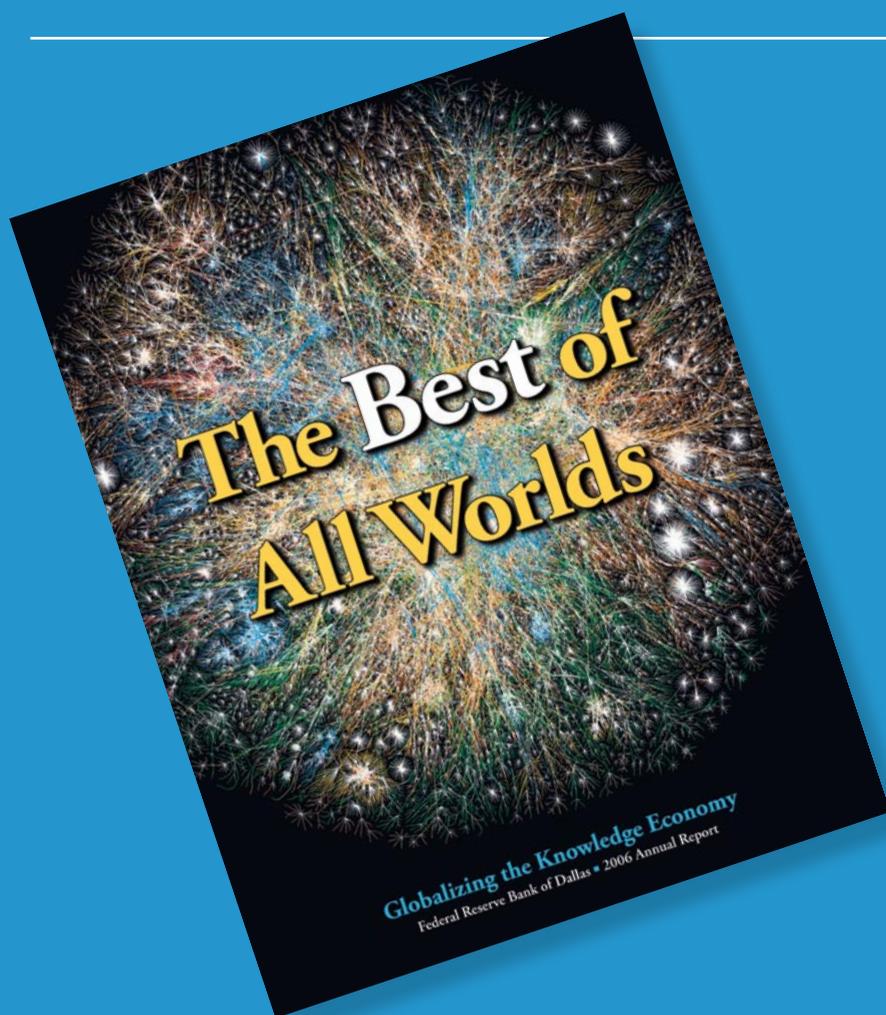
⁴ "The Individual Alternative Minimum Tax: 11 Key Facts and Projections," by Len Burman, Julianna Koch and Greg Leiserson, Urban–Brookings Tax Policy Center, December 1, 2006.

⁵ "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," Office of Tax Analysis, U.S. Department of the Treasury, July 25, 2006.

⁶ The National Commission on Social Security Reform, led by Alan Greenspan, proposed reforms in 1983 to address looming short-term financing problems. Among the recommendations enacted by Congress were increasing payroll taxes, adding employees to the system, increasing the retirement age for full benefits and taxing benefits.

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