Edward M Gramlich: Reducing budget deficits

Remarks by Mr Edward M Gramlich, Member of the Board of Governors of the US Federal Reserve System, at the Concord Coalition Budget and Fiscal Policy Conference, Washington, DC, 24 June 2004.

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Thank you for inviting me to speak today. Three years ago, at just about this time of year, I gave a talk about the supposed large and growing federal budget surpluses that were then being projected. It then appeared that the national debt could be paid off within the decade, and my remarks addressed the economic and political implications of this declining national debt. Unfortunately, much has changed for the worse since that time. Rather than expecting the stream of surpluses projected just three years ago, budget analysts now expect sizable deficits for at least the remainder of the decade. The national debt as a share of gross domestic product (GDP), which reached almost 50 percent in 1993 and declined to 33 percent by 2001, is now rising again. Today, I am here to talk about how to deal with our current worsening fiscal outlook.

Fiscal policy can have important long-run effects on the health of the economy, particularly through its impact on national saving and the growth of productivity. National savings can be generated privately, by households and business, or publicly, by government. Although fiscal policy can, in theory, help boost private saving, this has proven difficult, in practice. Instead, the most important effect of fiscal policy on national saving has been through the direct government budget. When the government runs deficits, it siphons off private savings (reducing national saving), leaving less available for capital investment. With less capital investment, less new equipment is provided to workers, and, all else being equal, future productivity growth rates and levels are lower.

Productivity growth is the principal source of improvement in economic well-being. The faster productivity increases over time, the more rapidly living standards increase. Maintaining a rapid rate of trend productivity growth is particularly important in light of the coming budgetary pressures associated with the retirement of the baby boom generation. A more productive economy will ease the financing of Social Security and Medicare benefits for tomorrow's retirees without placing an undue burden on tomorrow's workers. In contrast, if we allow debt to build now and in coming years, we will have both lower output to meet future obligations as well as the added burden of financing a growing amount of debt. Indeed, under numerous scenarios, our current debt path is unsustainable: without changes to taxes or spending, we may reach a point where ever-larger amounts of debt must be issued to pay ever-larger interest charges.

To be sure, budget deficits are not always inappropriate, and to a certain extent, the recent fiscal deficits have helped limit the recent economic slowdown. But now that the recovery is well under way, it is important to concentrate on longer-run fiscal policy. Specifically, it is time to bring the budget deficits under control. Doing so will, of course, require action in the political arena. But the manner in which the process of deficit reduction is framed can strongly influence the likelihood of success.

There are various ways to restore fiscal discipline. Today I will discuss some of these approaches, focusing on their past performance and future potential.

Better information

One approach is to provide the Congress with better information about the fiscal situation and the costs of legislation. The first milestone in that effort was the Congressional Budget and Impoundment Control Act of 1974. This act established the Congressional Budget Office (CBO) to provide baseline projections of current and future revenues and outlays and to estimate the budgetary effect of spending proposals. The act named the Joint Committee on Taxation (JCT) as the official "scorekeeper" for revenue legislation.

The CBO and the JCT provide credible estimates of taxes, spending, and deficits based on a common set of assumptions. By establishing a sensible context in which the inevitable political struggles associated with setting budgetary priorities can take place, this information significantly affects the budget process and, ultimately, budget outcomes.

Many analysts have worried about deficiencies in the concepts underlying the official budget estimates. Apart from a few exceptions, budget estimates are based on cash accounting. Thus, they do not take into account the accrual of future obligations or revenues and do not offer an accurate picture of the entire fiscal situation. For example, by today's cash-based yardstick, the federal budget posted surpluses from 1998 to 2001; yet, if the budget definitions had included the costs of future Medicare and Social Security benefits accrued over this period, the budget likely would have shown substantial deficits. Similarly, if our measure of national debt had included the present value of our already accrued future liabilities for Medicare and Social Security, the debt would never have been close to being paid off. In short, although cash deficits have economic relevance, they can provide a misleading picture of the nation's long-term budgetary situation.

Should the Congress try to target a better measure of the fiscal situation than the deficit as it is currently defined? Would providing the Congress with this better measure affect budget outcomes and help improve the fiscal outlook? Some have suggested moving to an accrual-based accounting system, where the deficit would better account for future obligations and revenues. Others suggest adopting the generational accounts framework. Rather than focusing on a particular year's imbalance between revenues and spending, this framework recognizes that, ultimately, we must pay for all government spending, and instead calculates the net burden of government taxes and spending on each generation.

Calculating generational accounts and other long-term budget measures requires many assumptions that are not as critical under today's rules. For example, to calculate generational accounts, one must specify the future path of numerous economic and demographic variables like wages, capital income, immigration, longevity, health costs, and inflation.[1] One must also specify a discount rate in order to calculate present values - a choice that would likely be controversial and that could greatly affect the results. Finally, one must assume something about future policy variables. Typically, generational accounts assume the continuation of current policy. Thus, they measure the fiscal burden under the assumption that current tax policy is continued, Social Security benefits are not curtailed, and Medicare spending continues to rise with health costs.[2]

The information provided by generational accounts and other similar methods would definitely be valuable, but their computational methods seem too complicated and rely too much on assumptions about future variables to make them a viable alternative to the current deficit as the main benchmark of fiscal policy. Moreover, much useful information about the future implications of current policy is already provided by the Office of Management and Budget and the CBO, both in their official five- and ten-year budget projections and in their longer-run projections. Targeting longer-term measures like generational accounts is further complicated by the fact that the estimates would be affected by promises to raise taxes or cut spending far off in the future. These very long-term calculations may be subject to a great deal of budgetary sleight of hand. Indeed, even the five- and ten-year targets currently used in the budget process have already been subject to considerable budget sleight of hand.

Most important, I am skeptical of the view that more information, as desirable as it is, would alone lead to greater budget discipline. The major differences between the various measures of the current fiscal situation stem from differences in their accounting for Medicare and Social Security. It is no secret to the public or to members of the Congress that these programs face long-term imbalances. This information has been widely known and studied in depth for many years. And yet, despite that fact, we still find ourselves on a fiscal trajectory that is probably unsustainable. Better information alone does not seem to be the answer to our fiscal difficulties.

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1 Typically, these are the types of assumptions used to provide long-term projections of the budget deficit or to calculate the long-term solvency of the Social Security system. To illustrate the uncertainty inherent in long-term projections, the CBOs most recent long-term outlook report focused on six possible scenarios based on different assumptions about future revenues and spending.

2 Determining future policy for tax rates is not clear-cut either. Under current law, tax revenues as a share of GDP will reach levels well above historical norms as real bracket creep pushes more and more income into the highest tax brackets. Yet, most calculations of generational accounts assume that the tax law will be adjusted so that average tax rates remain constant over time.

Overall deficit targets

A second approach to controlling budget deficits is for the Congress to establish budget targets. This approach was the centerpiece of the Balanced Budget and Emergency Deficit Control Act of 1985 - commonly known as the Gramm-Rudman-Hollings (GRH) Act. That act aimed to wipe out the deficit in five years. It did so by establishing annual targets - declining to zero - for the budget deficit. The process worked as follows: if projected deficits in the next fiscal year exceeded the targets by $10 billion or more, the legislation mandated that unprotected programs be cut, across-the-board, and by enough to reach the legislated targets. This process of across-the-board cuts was known as “sequestration”. The law did not specify how the targets were to be reached; instead, the assumption was that the existence of those targets and the threat of sequestration would be enough to get the Congress and the Administration to agree on a package of spending cuts and tax increases.

GRH did not allow changes in external circumstances to affect the budget deficit targets. Spending cuts were to be enforced regardless of whether the deficit picture had deteriorated because of worsening economic circumstances or because of congressional action. The result of this legislation was quite different than originally envisioned. A sequestration was enforced only once, in the first year. In other years, the Congress used various gimmicks to avoid sequestration, or it simply raised the targets. The actual deficit did not meet the target in any of the years GRH was law, in part because, during this period, external events, such as the savings and loan crisis, tended to overtake the policies that the Congress had enacted to try to close the budget gaps.

Other countries have also used budget targets as a means of enforcing fiscal discipline. For example, the Stability and Growth Pact of the European Monetary Union specifies that the budget deficits of member countries are not to exceed 3 percent of GDP except under some special circumstances. If they do, sanctions are to be imposed. But the Stability and Growth Pact has been as ineffective as GRH has, and for the same reasons: countries have resorted to budgetary gimmicks to meet the criteria, and the sanctions have not been imposed on countries that have not met their targets.

Another example of deficit targets comes from the balanced-budget requirements of the states, which can be viewed as deficit targets with the target set at zero. Most states have some form of balanced-budget requirement, although the form and stringency of the requirement varies considerably across states. In the most stringent cases, states are required to pass balanced budgets, and no borrowing is allowed to finance the operating budget. The states can use rainy day funds built up from previous years’ surpluses to finance current operations. The states keep capital budgets separate, and states are permitted to finance capital expenditures with borrowing.

The available academic literature suggests that these balanced-budget requirements do work, at least in part. Although states have a wide array of budgetary tricks they can and do employ to hit their deficit targets, research evidence suggests that the balanced-budget requirements do limit borrowing and that, as a result, states with more stringent requirements face somewhat lower borrowing costs. Furthermore, there seems to be a deeply held consensus that state budgets should be balanced, and this consensus undoubtedly helps legislators make the difficult choices sometimes necessary to balance state budgets.[3]

Hence, it may seem attractive just to limit overall deficits, but such limits have had only mixed success. They have typically worked, at least to a small degree, for U.S. states. For national governments, however, they typically generated more budgetary gimmicks than real cutbacks because the limits have not adjusted to the sources of fiscal shock. In a political setting, inflexible deficit limits are likely to lead more to avoidance than to real changes.

Controls on legislative action

A third approach involves tighter controls on legislative action. Even though GRH did not produce the budget balance it sought, the determination to improve the fiscal outlook remained. In response to the perceived failures of GRH, the Congress passed the Budget Enforcement Act (BEA) of 1990. This

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[3] There is a real question about the cyclical sensitivity of tax revenues. The states’ balanced-budget rules typically do not make adjustments for such sensitivity, but they effectively accommodate fiscal stabilizers because states, as mentioned, can build up rainy day funds in good years and run them down in bad years. A federal balanced-budget amendment would need to confront similar issues.

legislation replaced the system of deficit targets with two types of restraints on legislative actions. First, a cap was imposed on discretionary spending - spending that the Congress appropriates each year - and was to be enforced with a sequestration process. The cap declined slightly over time, in real terms. Second, for revenues and entitlement programs, the BEA established a system called PAYGO (pay as you go) that required all revenue and mandatory spending legislation to be deficit-neutral over a five-year period. For example, an expansion in a program like Medicare would be allowed only if it were accompanied by a reduction in other entitlement spending or an increase in revenues. In other words, the PAYGO restraint didn't require the Congress to climb out of the deficit hole by any particular date, but it did prohibit the Congress from digging the hole any deeper.

The largest difference between the BEA and GRH was that the BEA attempted to restrain legislative action alone. Changes in the deficit resulting from changes in economic conditions, health prices, demographics, and other technical or economic factors were allowed to show through to the deficit without sanction. Only those parts of the budget that the Congress could control directly - discretionary spending and programmatic changes to entitlement and revenue programs - were subject to the new requirements.

The BEA's budget rules - which were extended twice before they were allowed to expire in 2002 - appear to have been more successful than previous attempts at budget control. Budget deficits declined sharply from 1992 to 1997 and then turned to surpluses from 1998 through 2001. To a significant extent, of course, the decline in the deficit and the emergence of surpluses were attributable to circumstances external to the budget process, including the stellar performance of the economy; the increase in equity prices, which raised tax revenues to historic highs; and the end of the Cold War, which allowed for a decrease in defense spending.

But without a broad consensus to reduce the deficit, and without a mechanism to enforce that consensus, the Congress might have responded to these positive developments by increasing spending or cutting taxes. Instead, the federal deficit was allowed to decline. As a result, national saving increased, providing further impetus to economic growth. Most economists view these rates of national saving as an important factor in the strong economic performance of the late 1990s.

It is difficult to know exactly what the deficit path would have been in the absence of the BEA. But budget experts generally believe that the BEA did help to reduce deficits. How? A likely possibility is that the rules helped solve the prisoner's dilemma problem inherent in the legislative process. When representatives choose between seeking funding for local projects and exercising fiscal discipline (by not requesting funding for local projects), they will naturally consider the payoff of each choice. Without a set of credible budget rules, the narrow local interest is usually the more attractive option for two reasons. First, any individual representative knows that bringing home the pork is not likely to have much of an effect on the deficit. Therefore, there really is no measurable payoff in greater national fiscal virtue from an individual representative curtailing efforts to win special benefits for the home district. Second, in the absence of a credible set of budget rules, representatives have no assurance that others in the Congress will not be doing everything in their power to work the system to their benefit, and an individual representative would not want to appear to be relatively lax in his or her pork-procuring efforts. Budget rules help alleviate this problem. Under discretionary caps and PAYGO, individual representatives could choose to forgo their special projects, secure in the knowledge that others would not gain an advantage as a result.

As already noted, an advantage of the budget rules was that they aimed at constraining the things that the Congress could control directly rather than targeting the overall level of the deficit. But these rules also had a fatal flaw, which was that they had no sensible stopping point. Over the course of the 1990s, the economic news got better and better. The federal budget was borne along on the tide, and eventually moved into surplus, even excluding the Social Security cash surplus. At that point, a well-designed set of rules probably would have said "enough". But unfortunately, even when surpluses emerged, the PAYGO rules continued to require deficit neutrality in mandatory spending and revenue programs and adherence to the discretionary caps. Unfortunately, because such strict fiscal discipline was no longer viewed as necessary, the budget rules ceased to be effective: Congress enacted measures that reduced or eliminated their bite until they were finally allowed to expire in 2002. As a consequence of this aftertaste, it may be harder to bring back PAYGO rules now, when they are really needed.

A sensible strategy for the future

The main lesson to be learned from this examination of past budget rules is that, within limits, budget institutions do matter. A good budget process can help the Congress enforce fiscal discipline if the political consensus to do so exists. In order to be effective, the process must be based on reliable information about current and future baseline budget deficits and about the effects of legislation on the budget. It must produce results that are reasonable and valued by the Congress and the public. The process must be flexible enough to adjust in a reasonable way to changing economic and technical factors that affect the budget. Of course, no single set of rules can be flexible enough to address all possible circumstances, and over time, any set of budget rules likely will have to be revised.

Although the budget rules of the BEA did not prove flexible enough to endure in the face of budget surpluses, that is no longer an important problem. Reinstating both the discretionary caps as well as the PAYGO rules for revenue and mandatory spending programs - perhaps with some adjustments - would be useful initial steps in restoring fiscal discipline. Once some success has been achieved with these measures, it may be easier to tackle the more ambitious step of instituting overall deficit limits.

Two further issues are worth considering. First, what is the appropriate time horizon for budget rules? We have seen problems in the past with periods that were too short - for example, under GRH, the annual budget targets could be met by simply pushing costs into the next year. But there are also problems with periods that are too long - for example, when budget rules are satisfied by specifying painful measures that occur ten years in the future. The current focus on five years may be a reasonable compromise, or it might be worth considering some more-complicated rules that might limit annual deficits as well as five- or ten-year totals.

A second question concerns the ultimate target of budget rules. Should we, as a nation, aim to build up surpluses to fully fund all of our future Medicare and Social Security liabilities as they would exist under current law? Would that commit the government to maintain those programs as they are under current law rather than allowing the government to adapt them to future circumstances? Can the government reasonably accumulate the large stock of assets that full funding would require?

These are all difficult questions on which there is no political consensus. In the past, a reasonable goal might have been to maintain a zero deficit in our on-budget accounts - those accounts that exclude the Social Security and Medicare surplus - and to begin a serious discussion of reforms to Social Security and Medicare to bring them closer into actuarial balance. In the future, as the cash surplus for these retirement programs winds down, a proximate budget goal might be just a balanced overall budget (including the retirement programs), though we will still need to confront Social Security and Medicare issues.

As I have stressed, rules alone cannot create fiscal discipline where none exists. So, in conclusion, let me reiterate the most important point: restoring fiscal discipline should be one of our nation’s most important priorities. While the current deficits may not be terribly harmful in the short run, a failure to confront them now will steadily detract from the growth of the economy and will require even more wrenching changes in the future.