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# The Near-Term Outlook for Fiscal Policy

When I accepted the invitation several months ago to speak on the near-term fiscal outlook, I was not nearly as confused by it as I am today. But since that time, I have been confused, first by the implications of the methods used to enact appropriations this year and what these methods suggest about the sustainability of the budget rules that have served us well since 1990. It is not clear what will replace these rules and how future spending and tax policy will be affected. Second—and most important—I am confused by the economy and the stock market, which continue to defy, in a good way, most of what I thought I knew about macroeconomics and financial markets. If the good economic and financial news continues, my other confusions are unimportant and there is very little to worry about.

Let me expand a bit on my confusions and run the risk of leaving you as confused as I am. But before I look at the problems created by this year's deliberations, it is important to point out that the current fiscal situation is astonishingly good. The baseline unified budget surplus is large and growing, and both political parties promise to save a large portion of it. I would say that absent a significant recession, surpluses are almost certain to last for several years. Even a significant recession is unlikely to cause deficits large enough to break the downward trend in the debt-to-GDP ratio. In summary, it is the best fiscal situation since the 1920s. Sometimes that statement makes audiences nervous, but the 1920s were a good decade if we forget about that pesky last year. What all this means for the supply of public debt is difficult to estimate with confidence, but I shall give it a shot at the end of this talk.

Turning to the bad news, it appeared at the beginning of 1999 that the caps on discretionary spending for 2000 agreed to in 1997 would require a real cut of 5 to 6 percent compared with 1999 levels. Everyone knew that such a large cut was unrealistic and that the rational course would have been to renegotiate the caps to a level that was fiscally prudent but doable. In my view, that would mean caps that allowed a real increase in spending, but an increase that was less than GDP growth. However, many House members firmly believed that having very low caps would restrain spending more than would be the case if the caps were relaxed.

Ironically, I believe that this created a dynamic in which spending grew faster than it would have if there were no caps at all, because of efforts to boost spending early in the process. In the end, the Congress resorted to mechanisms to make it seem as though the caps were adhered to and as though the unified budget surplus would at least equal the surplus in the Social Security trust fund.

The use of such mechanisms is nothing new, but this year their importance reached an extraordinary level. To lower 2000 estimated spending, outlays were pulled forward into 1999 and delayed to 2001, while receipts were moved forward from 2001 to 2000. In addition, the Congressional Budget Office (CBO) was directed to use the lower outlay estimates of the Office of Management and Budget (OMB) to the tune of $23 billion, and

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liberal use was made of emergency provisions that exempt spending from the caps. The most extreme was declaring the 2000 census an emergency, even though we have known that we would have to have one since 1789. Emergency outlays will total $19 billion in 2000, but the emergencies provided for in 2000 will continue to affect outlays in 2001.

Correcting for timing adjustments and directed scoring, I believe that 1999 discretionary outlays would be about $579 billion while 2000 spending would rise to about $623 billion, for an increase in the spending base of close to 8 percent. This implies the largest real increase since the defense increases of the Vietnam era. It is important to note that you will never see an 8 percent increase in discretionary spending recorded on the books, but I think that it is a reasonable estimate, perhaps an underestimate.[1]

The key question is, what does all this imply for future years? Is it a temporary aberration or are we entering an era of large increases in discretionary spending after a long drought? Putting the matter another way, are we seeing a permanent increase in the size of the civilian government, perhaps financed with the cold war peace dividend, or is it a temporary surge, of the kind we saw around 1990?

It depends both on how the budget process evolves and how the economy evolves. The spending caps may be satisfied on paper this year, but for all practical purposes they are dead. Similarly, the pay-as-you-go rule requiring that tax cuts and entitlement increases be paid for with other tax increases or entitlement cuts for five years in the House and for ten years in the Senate was also violated this year.

For practical purposes, these official rules were replaced informally with a new constraining rule that says, "thou shalt not spend any of the surplus in the Social Security trust fund." If the CBO's July estimates turn out to be correct, that rule will also be violated this year. (The CBO has indicated that its January projections will be more optimistic.) And while I cannot imagine that real discretionary spending will continue to grow at this year's pace, it is my guess that we are entering a new era in which past stringency will be relaxed. If future discretionary spending growth is equal to GDP growth, I would guess that it will be sufficient to absorb all the on-budget surpluses projected under the CBO's more optimistic January 2000 assumptions.

The extreme sensitivity of budget projections to economic and technical assumptions makes the rule of balancing the non–Social Security budget impractical as a long-run constraining guide in the budget process. Changes in economic and technical assumptions over a six-month period can easily change estimates of that budget balance by $100 billion, when it is rare for policy changes to alter the balance by more than $50 billion. In other words, the Congress would be attempting to control something that is not really under its control in the short run. The time is sure to come when the CBO surplus forecast deteriorates by $100 billion or so over a relatively short period.

Moreover, the rule creates a bias toward on-budget deficits. Pleasant surplus surprises will be spent, whereas it will not be possible to adjust to adverse surprises. The latter problem afflicted the Gramm-Rudman-Hollings Act and was responsible for its demise. It was replaced by a much superior set of rules in 1990. What will happen when the new rule collapses? Will the 1990 rules be resuscitated? It is possible. But it is also possible that the new rule will be abandoned and that we will go back to trying to balance the unified budget deficit. I suspect that the latter is more probable—first, because I doubt that the new economic and technical assumptions will improve sufficiently to make it politically possible to balance the non–Social Security budget in the longer run, and second, because it will become more and more apparent that it is inane to imply that saving the Social Security surplus is directly linked to the prospects for paying future benefits. But even if we go back to the rule of balancing the unified deficit, there will be surpluses for several years while we make that transition.[2] But I may be too pessimistic about the extent to which the economic assumptions will continue to improve. I certainly have been in the past. In addition, endogenous changes in the ratio of revenues to GDP or in assumed cost growth in Medicare and Medicaid can have major effects on the long-run projections, but I suspect that those things are more likely to move in a pessimistic direction. The budget surplus in 1998 caught us by surprise, largely because of a surprising increase in the ratio of revenues to GDP and a surprising deceleration in Medicare cost growth. The revenue ratio rose from 18.8 percent in 1995 to 20.5 percent in 1998 and to 20.6 percent in 1999.

It is probable that a significant portion of the increase is related directly or indirectly to the booming stock market. Of course, rising capital-gains taxes have played a role, but ordinary tax payments by the very rich have risen remarkably, and that may also be related to the stock market. The share of tax revenues accounted for by taxpayers with an adjusted gross income above $200,000 went from 29.5 percent in 1995 to 37.2 percent in 1997, when such returns accounted for only 1.5 percent of total returns. The stock market, of course, generated huge incomes in the financial sector as well as increased the value of taxable withdrawals from retirement funds and reduced tax-deductible contributions to defined benefit pension plans.

The CBO projects that revenues will grow less rapidly than GDP until 2004, with the ratio falling to 20.1 percent. It is easily conceivable that a major stock market correction could lower the ratio another percentage point, resulting in a revenue loss of about $100 billion, even before considering the effect of the stock market decline on the economy. But surprises on the up side are also possible. One word of warning is necessary, however. The next set of CBO projections may contain a very large optimistic bias because they will have to assume that the ever-more-stringent spending caps of 2001 and 2002 are satisfied. There is not a chance in the world of that happening.

What does all this mean for the amount of public debt that will be outstanding over the next ten years? We start with such a superb fiscal situation that it is difficult for me to envision circumstances in which the debt-to-GDP ratio ten years from now would be higher than today's 41 percent. Everything that could go wrong would have to go wrong. The stock market would have to fall significantly, the economy would have to go into a prolonged recession, and medical costs would have to accelerate far beyond recent projections.

On the other side, it is extremely unlikely that the debt-to-GDP ratio will fall to the 6.4 percent projected for 2009 by the CBO in July, even with its more ebullient January economic assumptions. That is because of the difficulty of maintaining the on-budget surplus implied by current policy, and because of my previous assumption that pleasant surplus surprises will be used for tax cuts or spending increases while unpleasant surprises will only be partially countered by spending constraint. Note that the assumption implies a destabilizing fiscal policy in the long run, but Keynes said that in the long run we are all dead and he certainly is.

Election outcomes may affect the future size of government, but I doubt there will be much effect on the size of the deficit or the public debt. My remarks thus far imply a debt-to-GDP ratio lower than 41 percent and higher than 6 percent at the end of the next decade. Maybe I should just leave it at that. But I cannot resist noting that if we simply balance the unified deficit on average over the next ten years, the debt-to-GDP ratio will fall to about 26 percent in 2009, given the CBO's July GDP assumptions. Consequently, I think that the chances are considerably more than 50 percent that we shall get below the previous post–World War II low of 24 percent achieved at the end of fiscal 1974. And remember that a considerable portion of that amount—perhaps an amount as high as 6 percent of GDP—will be in the hands of the Federal Reserve. In recent years, an amount of debt approaching 20 percent of GDP has been held by foreigners and state and local governments. Private American investors will have to compete vigorously to hold any debt at all.

Unfortunately, I am old enough to remember that it was around 1974 when we last heard people worrying about a shortage of public debt. We sure jinxed the process then. Let us hope that we are not jinxing it now.

# Endnotes

1. In January and February 2000, the CBO and the OMB released new projections that improved the surplus outlook further. The president's budget adjusted for numerous budget mechanisms introduced during the appropriations process and it now estimates discretionary spending at $617.5 billion in 2000 and $575 billion in 1999, for an increase of 7.4 percent. I would move some additional monies from 1999 to 2000 and stick with my earlier estimate of an 8 percent increase. The numbers in the president's budget are lower than those that I used, in part because certain agricultural outlays that were earlier defined to be discretionary by the CBO have been reclassified as mandatory expenditures. Although both agencies added to their projected surpluses, I would not change any of the basic conclusions in this paper. As I will note, any increases in projected surpluses are likely to be used for future spending increases or tax cuts.

2. Any rule requiring a balanced unified budget is, of course, subject to the same criticisms as a rule requiring that on-budget outlays and receipts balance. Unified budget totals are as difficult to control, and there is no intellectual foundation provided by theoretical economics for the proposition that the unified budget should balance every year. However, balancing the unified budget has a very long history as an indicator of a responsible fiscal policy, and as long as it is an informal guide to policy rather than a formal rule enforced by a sequester, it can work pretty well.