Balancing the U.S. Budget

Professor Kevin Mumford
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Presentation Ground Rules

• No Normative Analysis
  – I will try to answer “what happened?” or “what would happen if ... ?” questions
  – Normative questions like “what is fair?” or “what should the government do?” depend on values (i.e. social welfare function) and are considered out of bounds for this presentation.

• Ask Questions
  – We learn more from a good discussion than we do from a good lecture
GDP is the market value of all final goods and services produced in the U.S. in a year

Source: Bureau of Economic Analysis (U.S. Department of Commerce)
Real GDP

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Source: Bureau of Economic Analysis (U.S. Department of Commerce), National Bureau of Economic Research
Federal Revenue and Expenditure as % of GDP

- Spending (red line)
- Revenue (green line)

Deficit/Surplus (yellow area)

Source: US Congressional Budget Office (historical budget data)
Federal Revenue and Expenditure as % of GDP

Source: US Congressional Budget Office (historical budget data) and (projections under current law)
Question: I balance my own budget, why can’t the federal government?

Answer: the government is not like a household
- Government is not going to retire (no need to save)
- Very low cost of borrowing (about 1% currently)
- A small deficit is very useful (financial markets)
- So, how large a deficit is OK?
  - This is a normative question!
  - It depends on the rate of economic growth
  - Economists get worried if the debt/GDP ratio increases
Federal Revenue and Expenditure as % of GDP

Source: US Congressional Budget Office (historical budget data)
Real Federal Government Debt

Debt Held by Federal Gov.
(Social Security)

Debt Held by Public

Source: US Congressional Budget Office (historical budget data), Dollars are in Billions of $2011
Federal Debt (held by public) as % of GDP

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)
What Caused the Increase in Debt?

% of GDP

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt); Pew Fiscal Analysis Initiative
What Caused the Increase in Debt?

- Great Recession
- Lower Revenue

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What Caused the Increase in Debt?

- Medicare
- Part D
- Great Recession Lower Revenue
- Iraq, Afghanistan & Other Defense
- Bush Tax Cuts
- Lower Tax Revenue from early 2000s Downturn
- CBO Projection (Jan 2001)

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What Caused the Increase in Debt?

- Medicare
- Part D
- Great Recession Lower Revenue
- Recovery Act
- TARP & Bailouts
- Other Spending Increases
- Other Tax Cuts
- Iraq, Afghanistan & Other Defense
- Bush Tax Cuts
- Lower Tax Revenue from early 2000s Downturn

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt); Pew Fiscal Analysis Initiative
What Caused the Increase in Debt?

- 31% Recessions (less income than expected)
- 29% New Tax Cuts (stimulus)
- 20% Spending (more than expected + new)
- 17% Defense Spending (more than expected)
- 3% Bailouts, TARP, loan guarantees, etc.
Question: What Do Budget Deficits Do?

What would change if the federal government had a 1% deficit rather than a 3.5% deficit?

Standard Macro Model

• Lower deficit → higher investment and net exports

• Over the long run (30 years)
  – higher wages
  – lower return on capital (lower profits)
  – higher GDP growth rate
  – future lower tax rates

• Magnitudes depend on how the deficit was reduced (higher taxes or lower spending)
CBO Federal Debt Projection

- Federal debt is projected to grow to 75% of GDP by 2014 (was 35% from 2000-2007)
Federal Debt (held by Public) as % of GDP

Actual Projection

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)
CBO Federal Debt Projection

- Federal debt is projected to grow to 75% of GDP by 2014 (was 35% from 2000-2007)
- This projection assumes current law will be left unchanged:
  - Bush Tax Cuts and AMT patch expire Dec 31, 2012
  - Dividend and capital gains tax rates go up on Dec 31, 2012
  - UI benefits reduced on Dec 31, 2012
  - Estate Tax rate increases to 55% in 2013
  - Budget Control Act ($2.1 trillion in spending cuts) happens
Federal Debt (held by Public) as % of GDP

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)
Federal Debt (held by Public) as % of GDP

Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)
Federal Government Revenue

**2001**
- **Personal Income Tax**: 50%
- **Corporate Income Tax**: 7%
- **Social Insurance Taxes**: 35%
- **Other**: 8%

**2012**
- **Personal Income Tax**: 46%
- **Corporate Income Tax**: 10%
- **Social Insurance Taxes**: 35%
- **Other**: 9%

*Federal Government Revenue 2001* $1,991 Billion 19.5% of GDP

*Federal Government Revenue 2012* $2,523 Billion 16.3% of GDP
Federal Government Spending

2001

Social Security 23%
Medicare 13%
Other Mandatory 18%
Other Discretionary 19%
Defense 16%
Interest 11%

$1,863 Billion
18.2% of GDP

2012

Social Security 20%
Other Discretionary 19%
Other Mandatory 22%
Defense 19%
Medicare 15%
Interest 6%

$3,601 Billion
23.2% of GDP
What are the Proposals to Reduce the Federal Debt?

1. Don’t worry about it today
   - Do we have an urgent deficit problem today? No
     - Unemployment is the urgent problem!
     - The U.S. can borrow at a zero real interest rate
     - We should spend more on:
       - stimulus, investment, job training, research funding
   - When does the deficit problem get urgent?
     - More than 10 years from now
Federal Deficit as Percentage of GDP
CBO Long-Term Projection

% of GDP

Total Deficit
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   • When does the deficit problem get urgent?
     – More than 10 years from now
     – But it’s not about overspending
     – It’s medical care! (Medicare, Medicaid, etc.)
Federal Deficit as Percentage of GDP
CBO Long-Term Projection

Total Deficit

% of GDP

2012 2022 2032 2042 2052 2062 2072 2082
Federal Deficit as Percentage of GDP
CBO Long-Term Projection

Deficit without Medical Care

Total Deficit

% of GDP

Deficit without Medical Care

2012 2022 2032 2042 2052 2062 2072 2082
What are the Proposals to Reduce the Federal Debt?

2. **Create a Federal Budget Constraint or Rule**
   (The US doesn’t have a fiscal policy, just fiscal outcomes)
   
   - **The policy would require spending cuts**
     - Health Care (reduce spending on Medicare & Medicaid)
     - Welfare Reduction (UI, Food Stamps, TANF, WIC)
     - Reduce Social Security Benefits (indexing, means-testing)
   
   - **And tax increases**
     - Increase marginal rates (focus on high-income taxpayers)
     - Remove corporate loopholes
     - Broaden the tax base (eliminate popular deductions, flat tax)
     - National Sales Tax (VAT)
Are we Headed for a Crisis?

• We put most of the budget on automatic pilot:
  – In the 1960s we created Medicare and Medicaid
  – In the 1970s we indexed Social Security to wage growth

• Our constitution makes it difficult for the federal government to get anything done.
  – Congress has nearly complete control of the US budgeting process (president only has veto power)

• Sometimes there are major federal reforms:
  – 1983 Social Security Reform (trust fund crisis)
  – 1986 Tax Reform (no crisis)

• But I’m worried that it will take a debt crisis
  – Joint Select Committee (super committee) failure
  – “Compromise” has become a dirty word in politics
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• Econometrics (ECON 560) – Master’s students
• Econometrics (ECON 360) – Undergraduates
• Public Finance (ECON 422) - Undergraduates