

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Making Sense of the Federal Budget Impasse

by David Altig

In November, the U.S. Congress passed the Balanced Budget Act of 1995. The bill provided a fiscal package that would, according to Congressional Budget Office projections, balance the federal budget by fiscal year 2002. On November 20, President Clinton signed into law a Continuing Resolution for Fiscal Year 1996 that provided short-term financing for most federal government operations. It also heralded an agreement between the President and Congress on the goal of producing a long-term budget plan that would eliminate the federal deficit on the seven-year schedule proposed in the Balanced Budget Act.

On December 6, the President vetoed the Balanced Budget Act, at the same time proposing the Administration's own seven-year plan. Consistent with the November Continuing Resolution, the President's plan undertook to eliminate the government deficit by 2002.

Although they concur on the balanced-budget goal and the time frame for achieving it, Congress and the President have been unable to agree on a specific plan that is mutually satisfactory. It now appears that no long-term budget plan will be passed in 1996, and that federal budget policy will consist of a series of short-term agreements to fund operations and avoid the liquidity crises associated with the Treasury's debt limit.

To many Americans, this impasse seems frustrating and confusing. Indeed, the popular press is often quick to characterize the problem as political gamesmanship, typical of an election year and devoid of substantive content. As long as there is consensus on the balanced-budget objective and the time needed to achieve it, isn't it silly to haggle over a few trivial details? Why not just split the difference between the Administration's plan and Congress's and let the economy begin enjoying the return to lower deficits?

This *Economic Commentary* has a simple message: All balanced-budget plans are not created equal, and broad agreement on a zero deficit by a given date does not preclude serious, reasoned differences of opinion on the economic consequences of a particular fiscal package. Central to this message is the proposition that changes in deficits per se provide few clues about the effects of fiscal policy changes. Put more directly, we should concentrate on the specifics of spending and tax policies: The total amount of federal expenditures matters less than what we spend and how we spend it. How much revenue we collect is less important than what we tax and how we tax it.

Although this is a fairly obvious point, readily acknowledged by almost anyone who thinks seriously about the issue, it is often overlooked in policy discussions.

**If Congress and the President can agree that they need to balance the budget, why are they still fighting over how to implement their goal? The continuing debate is not simply irresponsible posturing in the political silly season, but the result of serious, reasoned differences of opinion on the details of federal fiscal policy—the economic consequences of specific spending and tax decisions.**

In this *Commentary*, I use three simple examples to illustrate the problems that arise from focusing on the magnitude of the federal deficit rather than the fundamental tax and spending policies that underlie it. The three examples correspond to fiscal policy types that have already been considered, are currently being considered, or are likely to be contemplated in the future: a shift in discretionary spending from one activity to another, unfunded pay-as-you-go Social Security transfers, and a flat-tax proposal. All of them share the characteristic of having potentially large effects on the macroeconomy without making any impact at all on the federal budget deficit.

### ■ Spending Is as Spending Does

Consider the following change in government spending policy: One billion dollars that had historically been spent on constructing monuments to great leaders is shifted to the financing of public infrastructure projects like highways. The overall level of spending is, of course, completely unchanged by this policy. Consequently, the policy has no effect whatsoever on the federal deficit.

Would you be willing to argue that this policy is irrelevant simply because the deficit stayed the same? I would guess not. Then let's make the problem a bit more complicated. Suppose the \$1 billion expenditure on monuments was replaced with \$1.5 billion in infrastructure spending. In this case, the deficit rises by \$500 million, but does that make the policy a bad one? That is, will the policy have a deleterious impact on the economy? Again, we would likely conclude that a shift in federal spending from useless monuments to public capital investment is a positive development, despite the fact that the deficit becomes larger in the bargain.<sup>1</sup>

One possible objection to this example is that it involves false alternatives, since lawmakers rarely have the choice of replacing monuments with bridges and roads. More typically, the trade-off will be bridges and roads versus defense spending, education programs, research and development subsidies, or any number of other items, each of which has its own reasoned claim to the wallets, if not

the hearts and minds, of taxpayers. But that is really beside the point. We ultimately judge the government's expenditure policy as we do our own—less by whether that spending causes us to borrow more or less today, and more by whether the spending is consistent with the overall goals and desires that the policy supports.

### ■ The Burden of the Nondebt

This standard suggests that the evaluation of fiscal policy should be forward-looking. In one sense, projected paths of future deficits, provided and updated frequently as a standard part of ongoing federal budget activities, satisfy this criterion. In another sense, however, such projections miss the boat entirely.

Consider another example: When Mr. A is age 50, the government collects \$4,000 from him. When he is 65, the government transfers \$5,000 back to him. Where does the government obtain the \$5,000 for this payment? Assuming that it has long since spent the original \$4,000 it collected from Mr. A, there is a simple option: Tax Ms. B.

On its face, this policy seems fiscally responsible. In the year that Mr. A turns 65, the government's payment to him is completely balanced by receipts from Ms. B. But suppose that Ms. B has reason to believe that she will get the same deal as Mr. A. That is, for his "contribution" of \$4,000 at age 50, Mr. A was ultimately repaid principal plus "interest" amounting to roughly 1.5 percent for each of the 15 years up to age 65.<sup>2</sup> If Ms. B expects to be compensated in like fashion—paid the principal amount of \$5,000 plus annual interest of 1.5 percent after 15 years—then the balanced-budget transaction involving Mr. A and Ms. B actually creates an implicit liability equaling about \$6,250.

This simple example captures the more general fact that deficits per se are often meaningless signals of the burdens that current fiscal policies place on future generations. A stark reminder of this was provided in a recent Federal Reserve Bank of Cleveland study noting that, under current spending policies, future generations would face lifetime average

tax rates of more than 84 percent.<sup>3</sup> Spending reductions of a magnitude comparable to those in recent budget proposals would reduce this figure to about 75 percent.

As in the example given earlier, these large liabilities on future generations result primarily from implied social-insurance liabilities, specifically Old Age and Survivors Insurance and Disability Insurance (Social Security), Medicare, and Medicaid. Thus, a "simple" balancing of the budget by the year 2002 does not eliminate the enormous burdens that existing and potential fiscal policies will place on future generations.

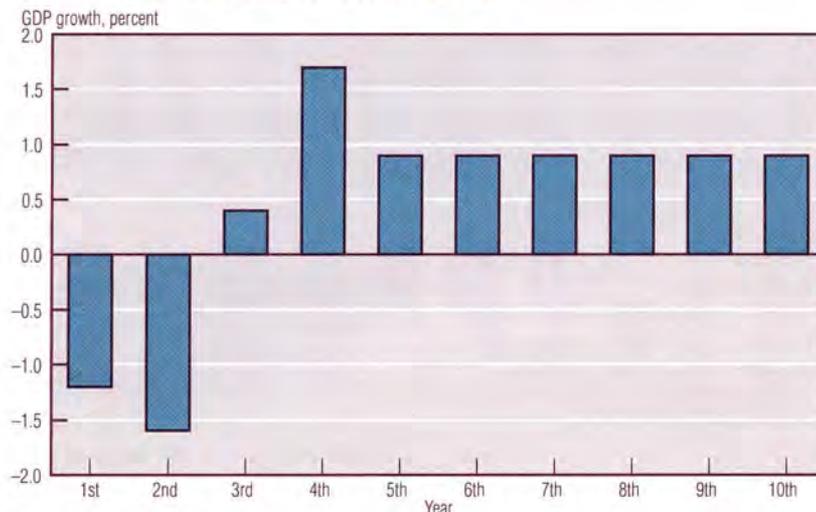
Redistributing resources to current generations has the inevitable consequence of increasing current consumption relative to investment. Lower investment means that future generations will inherit a lower capital stock than they would otherwise have enjoyed, which in turn will decrease their consumption opportunities. The normative aspects of these wealth shifts must, of course, be resolved in the context of the political process and the overriding social goals that inform it. Debate about the magnitude of the deficit, however, misses the point entirely, and does not address important issues that arise in the discussion of fiscal policy and intergenerational equity.

### ■ What If the World Were Flat?

One more example. Suppose that we replaced the current personal income tax code with a flat-tax system consistent with many of the proposals currently in vogue. Figure 1 illustrates one forecasting agency's estimates of how shifting to such a system would affect GDP growth, under the assumption that the tax change is revenue neutral at current income levels.<sup>4</sup>

Although not endorsing the particulars of these estimates—which, in any event, depend heavily on specifics such as nondeductibility of home-mortgage interest payments that are not in every flat-tax proposal—the example clarifies a basic truth about fiscal policy. Even when tax reform is deficit neutral, its economic impact can be large. In the early years, these projections suggest

**FIGURE 1 THE EFFECT OF FLAT-TAX LEGISLATION ON REAL GDP<sup>a</sup>**



a. The estimate for years 5–10 is an average growth rate for that period.  
**SOURCE:** Roger Brinner, Mark Lasky, and David Wyss, "Market Impacts of Flat Tax Legislation" (footnote 4).

**TABLE 1 THE COMPETING BALANCED-BUDGET PLANS (savings in billions of dollars, 1996–2002)<sup>a</sup>**

	Congress's Proposal	President's Proposal
Medicare	\$168	\$102
Medicaid	85	52
Welfare	60	43
Other mandatory expenditures	69	60
Tax cuts	203	87
Discretionary expenditures <sup>b</sup>	349	295

a. Entries represent cuts relative to current policy baseline.  
 b. Expenditures subject to annual appropriations.  
**SOURCE:** *Congressional Quarterly* (weekly report), vol. 54, no. 2 (January 13, 1996), p. 90.

that GDP growth would fall substantially below the rate that would be realized without tax reform. In later years, GDP would grow at a rate that is permanently higher than it would be otherwise.

The estimates shown in figure 1 illustrate that the levels of marginal tax rates, tax preferences for engaging in some activities (like owning homes), and tax penalties for engaging in others (like early withdrawal of funds from certain retirement accounts) all exert a powerful influence on when and how much people work, how much they save, and how they save it. These effects occur not because the deficit is rising or falling,

but because altering the tax system fundamentally changes the incentives to engage in particular economic activities. These incentives are at the heart of the economic effects of tax policy, and they bear little or no relation to the size of the federal deficit.

**■ Past the Deficit, into the Policy**

Each of our three examples emphasizes the critical importance of looking past the deficit when assessing federal fiscal policy. From this perspective, the latest budget proposals from Congress and the President appear far apart indeed.

Table 1 outlines the contours of the two plans. Each proposal would balance the budget in seven years. However, the devilish details include major differences in revenue and expenditure policies. Compared with current policy, Congress's plan would reduce spending on nonwelfare entitlement programs (including Medicare and Medicaid) by \$322 billion over the seven-year horizon. The President's plan would reduce that number to \$214 billion. Welfare would grow by \$60 billion less under the House and Senate proposal, but by \$43 billion less under the Clinton budget. Savings on discretionary spending would equal \$349 billion if the congressional budget is adopted, compared to \$295 billion if the President's plan prevails. Tax cuts sum to \$203 billion in the latest fiscal blueprint from the legislative branch; the corresponding total from the Administration is \$87 billion.

Even these gross numbers mask substantial policy differences. For example, in contrast to the President's proposed changes, Congress would end the entitlement status of the nation's welfare system. The elimination of guaranteed coverage for all qualified applicants obviously could have a significant impact on the implied future liability of the system. This difference goes far beyond the \$17 billion spending gap that separates the two proposals.

Nor is this example likely to be unique. Compared with Congress's budget, are the different discretionary spending priorities in the President's budget more like shifting resources from monuments to infrastructure, or vice versa? For the same amount of deficit reduction, what do the two budgets imply about the future liabilities of the federal government and the degree of intergenerational redistribution? Independent of the dollars involved, how do the two plans' tax changes differ in terms of the economic activities that they favor or disfavor?

These are exactly the issues that must inform any rigorous examination of fiscal policies. In the end, policies must be measured by the incentives and disincentives for wealth creation that they present. This *Economic Commentary* serves as a caution against interpreting the inability of Congress and the Administration to implement the agreed-upon budget balance as standard irresponsibility in the political silly season. On the contrary, the lack of a final long-term fiscal package can easily be seen as part of an honest, responsible debate about the parts of fiscal policy that really matter.

#### ■ Footnotes

1. This is not to say that the economic consequences of infrastructure spending are unambiguous. See, for instance, Kevin J. Lansing, "Is Public Capital Productive? A Review of the Evidence," Federal Reserve Bank of Cleveland, *Economic Commentary*, March 1, 1995.
2. Although the 1.5 percent return may seem meager, it very likely overstates substantially the rate of return that future Social Security recipients can reasonably anticipate. See Jagadeesh Gokhale and Kevin J. Lansing, "Social Security: Are We Getting Our Money's Worth?" Federal Reserve Bank of Cleveland, *Economic Commentary*, January 1, 1996.
3. See Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Restoring Generational Balance in U.S. Fiscal Policy: What Will It Take?" Federal Reserve Bank of Cleveland, *Economic Review*, vol. 31, no. 1 (Quarter 1 1995), pp. 2–12.
4. These estimates were taken from "Market Impacts of Flat Tax Legislation," by Roger Brinner, Mark Lasky, and David Wyss, *DRI/McGraw-Hill Review of the U.S. Economy*, June 1995, pp. 29–37.

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