

COMMENTARY

In a relatively brief paper, Alan Auerbach takes on a large task of trying to summarize and draw some conclusions from a quarter century's experience with fiscal policy. With a series of charts and tables, he provides a survey of the major themes in fiscal policy since the early 1970s; but the focus of the paper is on the effort to control the budget deficits that emerged after 1981. Auerbach argues convincingly that the 1981 tax reduction was the dominant event of the period and that it strongly influenced the future direction of both tax and expenditure policies. In my remarks, I would like to extend his theme by trying to ask what has changed as a result of our experience over the past twenty-five years. In that regard, I am most struck by two major innovations. First, in contrast to the late 1960s and early 1970s, fiscal policy has nearly disappeared as a serious tool of short-term stabilization policy. Second, after more than a decade of bitter partisan battles and frequent pronouncements of doom by economists, the budget deficit itself also simply disappeared.

In part, the decline in fiscal policy is simply a reflection of political partisanship that impedes cooperation on economic policy. But beyond the political factors, there are important economic reasons for its fading role. The stature of monetary policy has grown enormously compared with the 1970s. That ascendancy reflects a combination of change in the economic environment in which monetary policy operates, new insights into how to conduct it, and a continuing evolution of the longstanding debate within the profession about the relative

effectiveness of monetary and fiscal policy. U.S. monetary policy also emerged in the 1980s with a clear and simple set of policy priorities, something largely absent from fiscal policy.

However, before we write off fiscal policy too quickly as an unneeded redundancy, it is worthwhile to note that the ascendancy of monetary policy has occurred during a period in which the United States was faced with an extraordinary, benevolent economic environment. There have been no unfavorable economic shocks comparable to the energy price increases of the 1970s, and slow growth in the rest of the world has provided the United States with substantial gains in terms of trade. I think we can all agree that the primary credit accruing to the monetary authorities is that they have done nothing at a time when nothing turned out to be the best policy. Regardless, monetary policy has become the primary tool of short-run stabilization, with fiscal policy relegated to a backstopping role. That development has had the added benefit of allowing the focus of fiscal policy to shift toward longer term goals such as promoting economic growth.

Another surprise has been the dramatic reversal of the trend in the fiscal balance within the past few years. For more than a decade, large and growing budget deficits were at the center of any discussion of American budgetary policy. The inability of the Congress and the President to cooperate on a program of deficit reduction was central to the creation of a highly partisan paralysis of the federal government throughout the late 1980s and most of the 1990s. Yet today, the outlook is for a future of

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large and rising budget surpluses; and most surprising of all, that appears to have occurred without the Congress and the President changing policy in any considerable way.

The magnitude of the revisions to the outlook is highlighted in Chart 1, which shows the progression of the ten-year budget projections, based on current policy, of the Congressional Budget Office (CBO) from 1997 to the present. As recently as early 1996, the outlook was for large and ever-growing deficits that were expected to be about \$375 billion by 2005. Today, those same current policy projections show a surplus of \$300 billion by 2005, a turnaround of more than 30 percent of government outlays. Those revisions can be divided into three components: legislative actions, changes in the economic projections, and technical reestimates. Except for actions taken in 1997, legislative changes have played a trivial role in the changed outlook. And even in 1997, the Congress acted only in the sense of imposing discretionary spending limitations on future congresses.

Over the three-year period, the changes have been about equally split between revisions to the economic outlook and technical changes. In the summer of 1997, the CBO raised its estimate of the long-run growth rate from 2.0 to 2.3 percent annually and lowered the projected bond rate by half a percentage point. In addition, revisions to the national accounts indicated a much higher proportion of the GDP going to taxable forms of income. The result was a shift in the projected balance for fiscal year 2005 of more than a full 1 percent of GDP.

Further upward revisions can be anticipated in the year ahead.

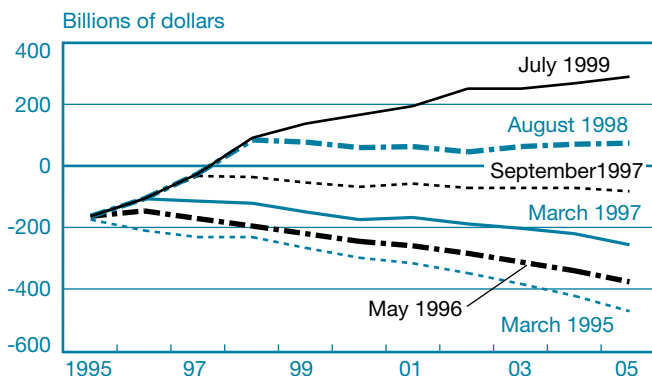
The technical changes can be traced in part to lower rates of growth in the medical programs, but the big surprise has been

on the revenue side, as personal income tax receipts have been far above expected levels in 1995-98. It has been difficult to account fully for the surge in revenues. There is a substantial lag in the availability of detailed data on personal income taxes, and there are two major competing explanations: a higher-than-expected flow of capital-gains taxes and a concentration of the aggregate income gains among high-income individuals with high marginal tax rates. At present, data are available only through 1997 and they suggest that both factors have been important, but the biggest contribution is from unexpectedly high capital-gains taxes. Initially, the CBO treated the revenue surprise as a transitory phenomenon and reduced the effective tax rate in future years, but it is now projected to continue indefinitely. There are, however, no new projected April surprises.

The current budgetary outlook is summarized in Chart 2. It is evident that the projected balance for the total budget is heavily dominated by the surplus in the Social Security account, which will continue until the baby-boom generation reaches retirement. Both political parties have pledged to save the Social Security surplus, and that statement is interpreted as necessitating a surplus or balance in the non-Social Security (on-budget) accounts.

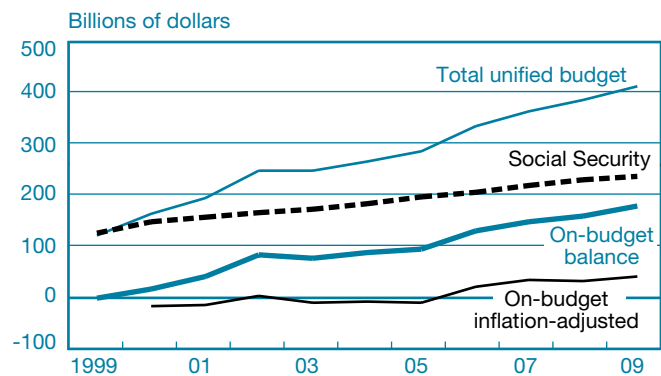
Exclusive of Social Security, the Congress will find it difficult to achieve balance in the fiscal year 2000 budget and beyond because the discretionary spending caps imposed in 1997 will become progressively more difficult to meet. In essence, discretionary expenditures, representing about one-third of the budget, are capped at their current nominal values. Furthermore, the effective tax rate is assumed to stay at

CHART 1
CBO Unified Budget Projections, 1995-99



Source: U.S. Congressional Budget Office; data compiled by Robert Reischauer of the Brookings Institution.

CHART 2
Projected Budget Balance, 1999-2009



Source: U.S. Congressional Budget Office.

Note: An inflation-adjusted balance allows for discretionary spending to grow in line with inflation.

its current high level. On that basis, the on-budget surplus would be substantial in future years, exceeding \$100 billion annually after 2005. But if discretionary spending is assumed simply to grow in line with inflation, there is no significant surplus.

Auerbach wants to argue that the current surpluses are illusionary because the Social Security trust fund will be in substantial deficit, beginning a quarter century from now. That is true, but I do not believe that it will negate the economic effect of a large surplus today. I doubt that projected unfunded future liabilities have the same effect as spending today, and I

am not sure that the calculation of an infinite-horizon budget balance helps the public or the Congress to evaluate the budget options before us. Unlike Auerbach, I would prefer to separate the public retirement funds from the rest of the budget and argue for a steady shift toward greater funding and a reduced emphasis on a pure “pay-as-you-go” approach. Much of the current discussion focuses on the distinction between discretionary spending and entitlements; but I think it misstates the issue to some extent. I agree with the point in Auerbach’s paper that the more relevant problem lies in the dominant role of budget programs that benefit the elderly.

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