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# The Deterioration in the US Fiscal Outlook, 2001–2010

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## Executive Summary

From 1999 to 2001, US budget surpluses averaged 2% of GDP. By 2011, the Congressional Budget Office was projecting persistent “current policy” budget deficits exceeding 6% of GDP, even after the economy recovered from the recession. This paper reviews the remarkable deterioration in the US fiscal outlook. It shows that more than half of the deterioration occurred before the 2007–9 recession, as a combination of tax cuts, increased spending, and worse than expected economic performance shifted the budget from surplus to deficit. The further deterioration since 2007 has two main components. Spending on Medicare, Medicaid, and Social Security is projected to increase by almost 3% of GDP over the first 10 years of baby boomer retirements, and interest costs are rising both because of the underlying fiscal imbalance and also as a result of the recession. The paper also discusses proposals for reducing the deficit, longer-term fiscal challenges, and the political economy of fiscal reform.

## I. Introduction

For more than 35 years, it has been evident that the 2011–20 period would be one of fiscal stress in the United States as the first baby boomers began receiving retirement benefits. The federal government has been making 75-year projections of its health and retirement programs for many years, and as early as 1974, these projections showed spending increases similar to the ones that are, in fact, occurring.<sup>1</sup>

In 1983, the United States instituted policy changes designed to prepare for this fiscal challenge, setting revenues for the OASDI program significantly above spending—with the explicit purpose of reaching our current point in history with a lower debt-to-GDP level than would otherwise have occurred. Facing large deficits in the early 1990s, the United States adopted a formal “pay-as-you-go” budget policy to prevent further fiscal deterioration in advance of the retirement of the baby

boomers. This policy required that any tax cuts or permanent new spending be offset so as to be deficit neutral or deficit reducing. When budget surpluses emerged in the late 1990s, President Clinton articulated a “save Social Security first” policy of dedicating the budget surpluses to debt reduction in advance of the baby boomers’ retirement. The US House of Representatives endorsed this general approach in 2000, voting 381–3 to use the portion of the budget surplus attributable to Social Security and Medicare for debt reduction. Between 1993 and 2001, federal debt as a share of GDP fell from 49% to 33%.

In 2002, the pay-as-you-go law was permitted to lapse, and what followed was a period of rising deficits. Tax cuts of roughly 2% of GDP were enacted without offsetting spending reductions. A significant new social insurance program, subsidizing the purchase of prescription drugs for the elderly and costing approximately 0.4% of GDP per year, was introduced, also without offsetting financing. In addition, spending increased for the security and war-fighting expenses of the post-9/11 period, with no new revenue collected for this purpose. In total, the fiscal balance worsened by about 4% of GDP, from surpluses that averaged 1.7% of GDP from 1999 to 2001 to deficits averaging 2.5% of GDP during the post-9/11, prerecession years of 2003–7.

With combined spending on Medicare, Medicaid, and Social Security projected to increase by almost 3% of GDP during the first decade of baby boomer retirements and with interest costs rising as a result of a variety of factors including the fiscal impact of the deep 2007–9 recession, there was a further deterioration in the fiscal outlook between 2007 and 2010. By January 2011, the Congressional Budget Office (CBO) was projecting that if current policies continued, the United States would experience persistent budget deficits exceeding 6% of GDP, even after the economy recovered from the recession—a remarkable deterioration from the budget surpluses of 2% of GDP that had existed just 10 years before.

During the past 3 years, Congress and the president have taken significant steps to bring down the budget deficit. In August 2011, discretionary spending caps and automatic enforcement procedures were enacted in the Budget Control Act of 2011 (BCA 2011), reducing projected out-year budget deficits by about 1.5% of GDP. In January 2013, changes were made to the tax code in the Taxpayer Relief Act of 2012 (TRA 2012) that are projected to reduce the annual deficit by about 0.4% of GDP. Current projections are that deficits will average about 3.5% of GDP during the coming decade and that the debt-to-GDP ratio will stabilize at approximately its current level of 75%.

Putting the debt-to-GDP ratio on a downward trajectory and preparing for future increases in government-funded health care costs would require additional adjustments. While there is a broad consensus around the menu of policy changes that could be used to reduce the long-term fiscal imbalances, there is no clear path to the political deal that will be necessary to enact the changes.

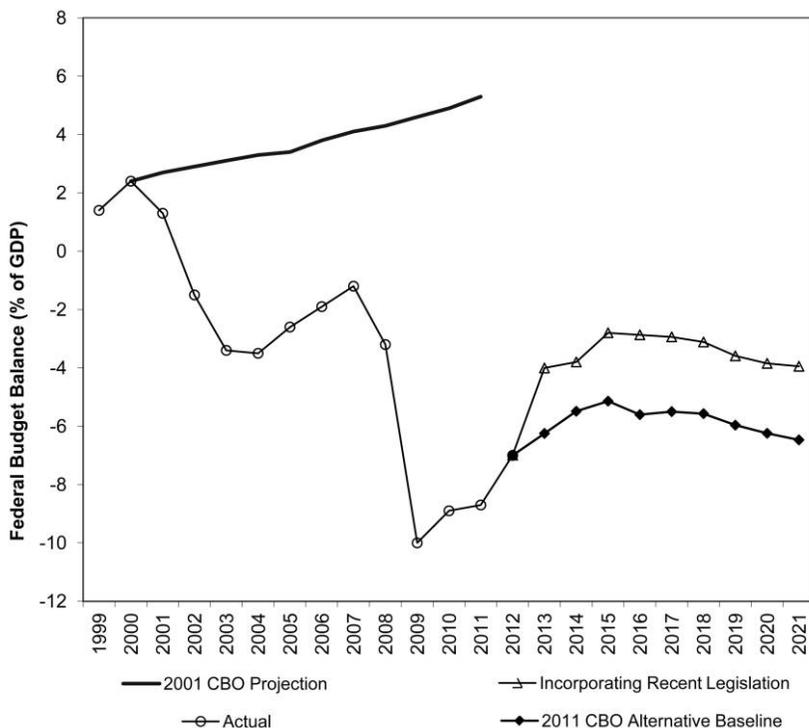
This paper begins by reviewing the deterioration in the US fiscal outlook over the 2001–10 period and the improvements that have occurred more recently. Next it discusses the outlook for additional deficit reduction over the coming decade and then turns to longer-term issues. It concludes with a discussion of the political economy of fiscal consolidation in the United States and the implications of fiscal rebalancing for economic growth.

## II. The Deterioration in the Fiscal Outlook

In 2000, the United States was running federal budget surpluses equal to 2% of GDP, and projections showed surpluses persisting far into the future. Debt-to-GDP had fallen from 49% in 1993 to 33% in 2000, nearly undoing the increase in the debt from 26% to 49% that had occurred between 1981 and 1993. Policy makers were actively debating the implications of the United States paying down all its publicly held debt, raising questions such as whether financial markets could tolerate a world without US Treasury bonds and whether the US government should use surpluses to acquire private-sector assets so that it could continue to issue debt to the public.<sup>2</sup>

By 2011, CBO was projecting persistent deficits exceeding 6% of GDP, even after economic recovery from the 2007–9 recession. Figure 1 shows the CBO's 10-year budget projections made in January 2001, the actual path of the deficit during that decade, and the 2011 CBO "current policy" projection of deficits in the coming decade.<sup>3</sup> The figure reveals that the United States was on a trajectory to experience a worsening of the budget balance of more than 8% of GDP over a period of 20 years. The figure also contains an update based on CBO's May 2013 projections that incorporates the 2011 discretionary budget caps and automatic enforcement provisions, the January 2013 tax legislation, and other more technical changes in the budget outlook.<sup>4</sup> These recent changes have improved the budget outlook by approximately 2% of GDP.

Table 1 shows that more than half of the fiscal deterioration happened prior to the 2007–9 recession. Discretionary outlays increased by 1.3% of GDP between 1999–2001 and the prerecession years of



**Fig. 1.** Deterioration of the US budget outlook. Source: CBO (2001, 2011a, 2013) and author's calculations. See notes 3 and 4 for additional details.

**Table 1**  
Components of US Federal Spending (Share of GDP)

	Actual 1999–2001 (1)	Actual 2003–7 (2)	CBO (2011) Alternative Baseline 2021 (3)	Updating for Recent Legislation 2021 (4)
Social Security, Medicare, and Medicaid	7.5	8.0	11.3	10.6
Interest	2.3	1.5	4.0	3.1
Discretionary spending	6.3	7.6	6.6	5.6
Other mandatory	2.3	2.6	2.8	3.0
Total outlays	18.3	19.8	24.7	22.4
Revenues	20.0	17.3	18.2	18.5
Surplus	1.7	-2.5	-6.5	-3.9
Unemployment rate	4.3	5.2	5.3	5.4

Source: OMB and CBO historical tables, CBO (2011a, 2013), and author's calculations. See notes 3 and 4 for additional details.

2003–7 primarily because of spending associated with the wars in the Middle East and the increased homeland security expenditures in the aftermath of the September 11, 2001, attacks. Mandatory spending rose by almost 1% of GDP as a new prescription drug program for the elderly was enacted, health expenditures continued to rise, and refundable tax credits (scored as outlays) were expanded. Neither the security spending nor the new drug program was accompanied by any significant offsetting spending cuts or revenue increases. Moreover, revenues were reduced by about 2% of GDP via legislation passed in 2001 and 2003. This tax legislation reduced marginal tax rates at all income levels, reduced the preferential tax rates that apply to dividends and capital gains, and expanded middle-class tax expenditures such as child tax credits. The weaker than expected economic performance of this period also contributed to the 2.7% decline in revenue as a share of GDP.<sup>5</sup> To a large extent, the fiscal deterioration of this period was a replay of the Reagan years—with tax cuts and increased security spending producing higher deficits.

Before turning to the further deterioration that is projected for the coming decade, it is necessary to discuss the several alternate budget projections that are available for the United States. The most widely used projections are those of the nonpartisan CBO, an independent budget agency established by Congress in 1974. The CBO is required to make its projections on the basis of “current law.” In particular, if a tax cut or spending program is scheduled to expire, the CBO assumes in its projections that the policy will indeed expire. This convention has enabled policy makers to mask the true out-year deficit impact of policies by scheduling policies to expire even though they are intended to be permanent. The 2001 tax cuts were scheduled to expire after 10 years for this reason. A large set of business tax preferences expire and are renewed annually, masking their out-year impact on the deficit. In addition, Congress has annually indexed the income thresholds for the alternative minimum tax for inflation, but only for one year at a time, again obscuring the out-year deficit impact. Finally, Congress has legislated a 20% reduction in payments to doctors under Medicare. Every year this cut is undone for the current year only, allowing Congress to spend money without showing the out-year deficit impact.

In addition to its baseline budget projection, the CBO has, in recent years, presented a second projection that it refers to as its “Alternative Fiscal Scenario.” This alternative projection shows the budget path that would occur if the tax and spending policies in place for the current year were extended into the future and is often referred to as a “current policy” projection.<sup>6</sup> TRA 2012 made most provisions of the personal

income tax permanent and also permanently indexed the alternative minimum tax thresholds. Thus, the gap between projections based on “current law” and those based on “current policy” is now much smaller than at any point since the 2001 tax cuts were enacted. Nonetheless, for consistency, all projections in this paper reflect a current policy concept.

Returning to table 1, we see that the deterioration in the current policy budget outlook between the prerecession period and the CBO (2011a) alternative baseline projection for 2021 had two main components. First, spending on the big social insurance programs, Medicare, Medicaid, and Social Security, was projected to grow by 3.3% of GDP as the baby boomers begin to retire. Second, interest on the debt was projected to grow by 2.5% of GDP, reflecting rising debt levels and the resulting higher interest rates.<sup>7</sup>

The increase in debt levels between 2007 and 2021 has three main components. First, there is the combined impact of the prerecession deficits and the increased health and retirement spending. Second, there are the direct effects of the recession: of falling revenues and increased automatic stabilizer spending on programs such as unemployment insurance because of the economy being below its potential. Third, there is the impact of the American Recovery and Reinvestment Act (ARRA) and other stimulus efforts. Parsing out the relative contribution of each is challenging because of issues of stacking order and interactions. But a rough accounting suggests that 45% of the increase in debt is due to the first category, 25% is due to the direct effects of the recession,<sup>8</sup> at most 20% is due to the policies that were undertaken to combat the recession, and the rest is due to interactions.<sup>9</sup>

Whereas spending on social insurance and interest is projected to rise rapidly over this decade, discretionary spending, the 30% of spending that is appropriated annually, is projected to fall significantly as a share of GDP because CBO convention is to assume that discretionary spending grows at the rate of inflation. Table 1 shows that the CBO 2011 alternative scenario projected discretionary spending to fall from 7.6% of GDP in the prerecession period to 6.6% of GDP in 2021. Part of this decline in discretionary spending is due to spending cuts that have already occurred. Between 2000 and 2008, nominal discretionary budget authority grew at an annualized rate of 9.2% per year. In inflation-adjusted dollars, it grew at a 6.1% rate. In contrast, between 2008 and 2012, nominal discretionary budget authority grew at an annualized rate of 0.3%, and in real dollars it has fallen at a 0.8% annualized rate.<sup>10</sup>

The BCA of 2011 set caps on discretionary spending that would result in discretionary spending growing at a rate that is below the inflation

rate and well below the GDP growth rate. BCA 2011 also requires additional cuts in discretionary spending through automatic enforcement provisions that are in effect because Congress failed to pass subsequent deficit reduction. In combination, the caps and automatic enforcement provisions are projected to reduce discretionary spending to 5.6% of GDP by 2021, which would be the lowest share of GDP in more than 50 years. That said, most of the difficult policy decisions necessary to reduce spending to the cap levels have not yet been made. Below I discuss the history of past efforts to constrain spending using discretionary caps.

The changes to the tax code enacted in TRA 2012, most notably reverting to pre-2001 marginal tax rates for taxpayers with taxable income above \$400,000 (\$450,000 if married) are projected to reduce the annual deficit by about 0.4% of GDP. In addition, for the past 3 years, health care costs have grown much more slowly than projected, leading to lower projected spending on Medicare and Medicaid. Taken together, the “current policy” deficit projection for 2021 has declined from 6.5% of GDP to 3.9% (table 1).

### III. Prospects for Further Deficit Reduction

Table 2 compares the spending and revenue levels in the CBO 2011 alternative baseline with those in four deficit reduction plans: President Obama’s February 2012 budget, the plan released by the National Commission on Fiscal Responsibility and Reform (2010; generally referred to as the “Bowles-Simpson plan” after its two cochairs), the Bipartisan Policy Center plan (generally referred to as the “Domenici-Rivlin plan”; Debt Reduction Task Force 2010), and the 2012 budget resolution of the Republican-controlled House. There are several reasons why the numbers for the different plans are not strictly comparable. For example, the president’s budget uses different economic assumptions and budget baselines than the other plans, which rely on CBO estimates, and the president’s budget proposes to reclassify certain categories of discretionary spending as mandatory spending. In addition, the plans vary considerably in the amount of specificity provided about intended policy changes, with the president’s budget giving the most detail and the House budget resolution providing the least detail. Nonetheless, the table illustrates that all of the plans envision noninterest policy adjustments of between 3% and 4% of GDP. The president’s budget and the two bipartisan reform plans contain revenue increases of approximately 2% of GDP and noninterest spending reductions of between 1% and 2% of GDP. The House budget resolution would reduce noninterest spending by 3.7% of GDP.

**Table 2**  
Reform Proposals (Share of GDP)

	CBO (2011) Alternative Baseline 2021	National Commission on Fiscal Responsibility Bowles-Simpson 2021	Bipartisan Policy Center Domenici-Rivlin 2020	President's Fiscal Year 2013 Budget 2021	House 2012 Budget Resolution 2021
Social Security, Medicare, and Medicaid	11.3	10.9	10.4	10.7	10.1
Interest	4.0	3.1	2.8	3.1	2.5
Discretionary spending	6.6	5.1	6.2	5.2	5.1
Other mandatory	2.8	2.7	2.6	3.4	1.9
Total outlays	24.7	21.8	22.0	22.5	19.5
Revenues	18.2	20.3	20.5	19.9	18.6
Surplus	-6.5	-1.5	-1.5	-2.6	-9

As mentioned above, Congress has already enacted a significant portion of the needed adjustments. When combined with the wind-down of operations in Afghanistan, the discretionary spending caps will reduce discretionary spending to approximately the level envisioned in these plans. In addition, TRA 2012 increased revenue by about 0.4% of GDP.

To see why it will be challenging to enact additional policy adjustments of the targeted size, it is helpful to return once again to table 1. In 2021, almost two-thirds of government spending will be for interest costs, Social Security, Medicare, and Medicaid. And these categories of spending are projected to account for more than 100% of the increase in spending since 2003–7. But the amount of spending cuts achievable in these categories during the 5–10-year horizon for stabilizing debt-to-GDP is quite limited. Spending on interest costs can be affected only indirectly. Social Security is funded primarily with a dedicated revenue stream, and the solvency of the system is usually judged on a 75-year basis. Social Security reform proposals almost always phase in benefit cuts and tax increases gradually so as to exempt current retirees and near retirees from benefit cuts and current workers from immediate tax increases. Thus, even a Social Security reform that was projected to produce long-run financial stability for the program would likely do little to improve the medium-term fiscal outlook. For example, the Social Security plans in the Bowles-Simpson Commission report and the Bipartisan Policy Center report reduce the deficit by just 0.2% of GDP in 2020.

It will similarly be challenging to make a significant dent in Medicare and Medicaid spending over the medium term. The 2010 Affordable Care Act (ACA) included \$455 billion in spending reductions in these programs over the coming decade. In theory, it would be possible to “double down” on the cost savings provisions in the ACA, for example, by accelerating some of the payment reforms that are currently scheduled to be rolled out gradually as pilots. In practice, congressional Republicans are trying to repeal many of the provisions of the ACA, and it will be challenging to maintain the cost savings that have already been legislated, much less to introduce significantly more aggressive policies to reduce costs. The president’s budget contains about 0.2% of GDP in additional savings from health care programs, and the two bipartisan commission plans contain a similar amount. All three of these plans also reduce spending on other mandatory programs such as agriculture subsidies and civil service pensions, but these additional spending cuts total less than 0.2% of GDP. Thus, if these proposals can be taken as representative of what is politically feasible, achievable savings

on the mandatory side of the budget over the coming decade are likely to be around 0.5% of GDP.

With further policy adjustments of approximately 2.0% of GDP necessary to reach the fiscal sustainability targets set in these plans and only around 0.5% of GDP of adjustment likely to come from mandatory spending, the remainder will need to come from discretionary spending and increases in revenue. As noted above, discretionary spending under the discretionary caps is already projected to fall to historically low levels. Whether the cap levels will actually be achieved is unknowable. The conventional wisdom about the discretionary caps of the 1990s is that when they were set at “reasonable” levels, Congress and the president abided by the caps. But when, toward the end of the decade, the caps were set at levels that many legislators perceived as being unrealistically low, the appropriations process simply ignored the caps.<sup>11</sup>

Overall, while there are conceivable scenarios in which spending reductions of more than 1% of GDP are achieved by the end of the decade, it seems more likely that the political process will produce savings of between 0.5% and 1.0% of GDP. Moreover, the savings achieved over the next 5 years are likely to be toward the low end of this range. This observation implies that additional revenue of at least 1.0% of GDP will be needed by the middle of the decade to start to reduce the debt-to-GDP ratio. Three of the four deficit reduction plans—the president’s budget and the two bipartisan plans—recommend additional revenues of roughly this amount.

There have been three main approaches to raising revenue that have received significant attention in the United States in recent years, all of which could raise at least 1.0% of GDP in additional revenue. The first approach was to let the 2001/3 tax cuts expire as scheduled at the end of 2012. Doing so would have raised roughly 2% of GDP in new revenues and would not have required policy action. However, in January 2013, Congress and the president decided to make most of these tax cuts permanent, raising only about 0.4% of GDP in new revenue from letting marginal income tax rates in the top tax bracket revert to their pre-2001 levels and setting the tax rate on capital gains and dividends at 20%, among other changes.

The second approach to raising revenue is to broaden the tax base by reducing tax expenditures. The US tax code excludes many items from taxation that would be included in an ideal (Haig-Simons) income tax base; for example, compensation received in the form of employer-provided health insurance is not taxed. It also contains expensive tax

deductions for items such as mortgage interest and state and local taxes paid. Finally, it administers spending-like programs through the tax code, such as tax credits for college tuition. Cutting back on tax expenditures offers the opportunity to raise revenue without raising tax rates while simplifying the tax code and, in some cases, eliminating the economic inefficiencies that come from the deviations from the ideal tax base. The challenge here is that most of the largest tax expenditures are quite popular. Recently there has been discussion of an approach that would allow most of the existing tax expenditures to remain but cap the total amount of tax expenditures that a taxpayer may claim (Feldstein, Feenberg, and MacGuineas 2011; Baneman et al. 2012). This approach is likely to be more politically feasible than attempting to directly eliminate any specific tax expenditure.

The third approach is to introduce a value-added tax (VAT) to supplement existing revenue sources. The United States is the only OECD country without a VAT. Because Americans are accustomed to paying retail sales taxes assessed by state governments and because the VAT has negative connotations of being associated with European social welfare states, proposals for a US VAT generally describe it as a “national retail sales tax.” In the short term, the VAT appears much less likely to be enacted than the other two revenue approaches. The idea has received little serious discussion outside of academia and think tanks, and it would be perceived as more radical by most Americans.

It is, of course, possible to combine the three approaches to raising revenue. The president’s budget proposal recommended allowing the 2001/3 tax cuts to expire for income ranges above \$250,000 while limiting tax expenditures both by capping the rate at which itemized deductions can be claimed and by eliminating subsidies for fossil fuel production. The two fiscal commission proposals aggressively cap tax expenditures and overshoot their revenue target so as to allow marginal tax rates to come down.<sup>12</sup> The Bipartisan Policy Center proposal includes a 6.5% “debt reduction sales tax” as well.

In general, the political feasibility of revenue increases is no greater than that of the more aggressive spending cuts. In particular, a large fraction of Republican elected officials have publicly committed to opposing any tax increases. However, because tax expenditures can be interpreted as government spending that occurs through the tax code, there appears to be an opportunity for a bipartisan agreement on tax expenditures that would allow Republicans to claim that they are reducing this large category of government “spending” and Democrats to claim that they have managed to increase government revenue.

It is also worth emphasizing that there is considerable uncertainty about the exact magnitude of the policy adjustments necessary to achieve any deficit reduction target. Relatively small percentage changes in revenue or spending levels can result in large changes in the deficit. If the economy or health care costs grow somewhat faster or slower than currently projected, the impact on the deficit could easily be larger than most of the policy adjustments currently being contemplated. Indeed, on the basis of historic forecast errors, Office of Management and Budget (2012) projects that the 90% confidence interval around its 2017 budget deficit projection extends from a surplus of 3.8% of GDP to a deficit of 9.8% of GDP.<sup>13</sup>

#### **IV. The Longer-Term Outlook: Demographics and Health Care Expenditures**

Even if the United States is successful at stabilizing or reducing the debt-to-GDP ratio within the next 5–10 years, longer-term fiscal challenges associated with population aging and rising health care expenditures will remain.

The United States has a more favorable demographic outlook than many European countries. The US total fertility rate has averaged slightly above 2 for the past 20 years, and current projections from the OASDI actuaries are for a long-run fertility rate of 2.0. With immigration rates projected to continue to exceed 1 million per year, the US labor force is expected to increase by 0.5% per year between 2019 and 2050 (OASDI Trustees 2013).

As discussed above, the retirement of the baby boom generation is leading to a dramatic increase in social insurance spending. But the demographic burden is projected to stabilize within the next 15 years. The number of workers per OASDI beneficiary will fall from 3.3 in 2007 to 2.3 in 2025. But beyond 2025, this ratio will fall very gradually, reaching 2.1 in 2065. OASDI spending as a share of GDP will rise from 4.2% in 2007 to 5.8% in 2025. Between 2025 and 2065, expenditures on these old-age and disability benefits are projected to remain nearly constant, reaching only 5.9% of GDP in 2065 (OASDI Trustees 2013).

Unlike Social Security spending, government spending on health care is not expected to level off anytime soon. Since 1975, expenditures per beneficiary on the two main government health care programs, Medicare and Medicaid, have grown at an average annual rate of 2% faster than per capita GDP. The CBO projects that federal spending on health programs will increase by 2.9% of GDP between 2022 and 2037 under

its extended alternative fiscal scenario (CBO 2012b). By comparison, the primary deficit in 2021 after recent deficit reduction legislation is under 1% of GDP.

Spending a higher share of society's resources on health care over time can be a rational response to rising income levels. Hall and Jones (2007) show that with diminishing returns to consumption in any given period, an important way to increase lifetime utility is to add extra periods of life. Moreover, with rising income levels, it is possible to simultaneously spend a rising fraction of income on health care and to increase consumption (although at a slower rate) of non-health care goods and services. Research suggests that the average benefits of increased health care spending in the United States have exceeded the average cost (Cutler, Rosen, and Vijan 2006). Nonetheless, there are reasons to believe that a significant portion of US health care consumption is inefficient (Garber and Skinner 2008), and the extent to which US health care spending exceeds that of other countries is extraordinary even after adjusting for levels of per capita income (Reinhardt 2008). Even if rapidly increasing health care spending were optimal, it would still create a fiscal challenge. Since about half of US health care spending is government financed, such a path would imply steadily increasing tax rates.

In recent years, health care experts in the United States have suggested a long list of changes to eliminate inefficiencies in the system (Engelberg Center for Health Care Reform 2009). These include moving the payment regime away from paying based on the quantity of services delivered and instead paying on a capitated basis or based on measures of health care quality outcomes. They also include investing more in learning about the clinical effectiveness of different treatments and pricing unproven treatments differently than proven ones. And they also include streamlining administration, eliminating the tax incentive to overconsume health insurance, reforming the medical malpractice system, standardizing insurance plans to facilitate quality- and price-based competition, and investing in health information technology and electronic medical records. The 2010 ACA contained elements of all of these recommendations, though in many cases only in a pilot form. The CBO estimates that the ACA reforms will reduce the deficit by over \$1 trillion in its second decade of operation. Some health care experts think that with proper implementation, these reforms could produce much greater savings (Cutler 2010). Other experts suggest that many of the cost savings provisions will not be politically sustainable and will be repealed before they go into effect (Holtz-Eakin and Ramlet 2010).

Many countries use hard budget caps to limit health care spending, setting aggregate budgets at the provincial or hospital level and requiring providers to deliver care within that cap. A plan consistent with this approach has recently been promoted by Representative Paul Ryan, the Republican chair of the House Budget Committee, along with Alice Rivlin, one of President Clinton's budget directors. The Ryan-Rivlin plan would replace the current US system of government-provided health insurance for seniors with a new system in which Medicare recipients would receive a fixed sum and purchase insurance from private insurance companies. Under the Ryan-Rivlin plan, the government contribution, and therefore Medicare costs per beneficiary, would grow at GDP + 1%, essentially cutting excess cost growth in half. Under this system, seniors would bear the risk associated with health care costs growth exceeding GDP + 1% as they would be responsible for paying the portion of the insurance premium that was not covered by the government.<sup>14</sup>

Most likely the coming decade will be one of messy innovation in the US health care system, as different states use the flexibilities and financial incentives provided in the ACA to try different approaches to cost control and quality improvement. In the United States, state governments are often described as the laboratories of democracy since successful innovations demonstrated in one state can be expanded nationwide. If at least a few states find a way to reorganize to provide higher-quality care at a lower cost, then the approach of learning what works and testing different payments systems may continue to be the main policy response to health care cost control for the United States in the near future. However, if excess cost growth persists at 2% a year for another decade, then the blunter approach of directly setting expenditure levels could emerge as a politically viable alternative.

## V. The Political Economy of Reform

There is a relatively recent precedent for the United States correcting a fiscal imbalance. From 1982 through 1997, the United States faced what appeared to be an intractable budget deficit problem. It required three pieces of deficit reduction legislation—in 1990, 1993, and 1997—each of which reduced deficits by approximately 1% of GDP, along with the good fortune provided by a booming economy, to turn the persistent budget deficits into surpluses.

None of the budget deals were easy. The tax increases in the 1990 deal contributed to President George H. W. Bush's defeat in 1992. Several first-term Democratic members of Congress who voted for the 1993

deficit reduction package lost their seats in the 1994 election in part because of this issue. And the path to the 1997 budget deal involved a 3-week government shutdown in December 1995. This history is a useful reminder that the US political system does not need to be perfect in order to accomplish a fiscal rebalancing. Congress and the president can fail to accomplish deficit reduction in two out of three years and in the successful years make only one-third of the targeted amount of adjustment, and still the United States could end up with sufficient policy changes over a decade to produce a declining debt-to-GDP ratio. Indeed, the deficit reduction achieved in the BCA 2011 and TRA 2012, despite appearances of dysfunction in Washington, suggests that this process is already under way.

In the comparative budget policy literature, it is a bit of a puzzle as to why the US political system has historically done as well as it has in keeping budget deficits low. As a presidential country with a frequently divided government, the United States and its “checks and balances” system has a bias toward inertia that, in theory, should make it difficult to address fiscal imbalances. In contrast, parliamentary coalition governments can use fiscal contracts among coalition partners to implement fiscal consolidations, with the contracts enforced by the threat of the government falling. Parliamentary majority governments can vest decision making in the finance minister (von Hagen 2006). Yet the US political system managed to enact major deficit-reducing legislation in 1983, 1990, 1993, and 1997 and to produce a federal debt-to-GDP ratio of 36% before the recent recession. Eichengreen et al. (2011) speculate that US voters are not focused solely on minimizing their tax payments and maximizing the government spending they receive; they also care deeply about the health of the economy and therefore reward elected officials who correct fiscal imbalances.

## VI. Conclusion

The policy adjustments that will be required for the United States to stabilize its debt-to-GDP level over the next decade and start it on a downward path are not large relative to policy adjustments that have occurred in the recent past. If past history is a guide, the political system will ultimately make the needed adjustments. But fiscal policy is not simply about satisfying the government’s intertemporal budget constraint. It has large implications for the health of the economy. In the short run, policy makers face the challenge of accomplishing fiscal consolidation without choking off the economy’s recovery from the recent recession. In the

longer run, choices about which spending gets cut and how additional revenue gets raised will affect the economy's growth rate.

## Endnotes

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1. Detailed 75-year projections of the Old-Age, Survivors, and Disability Insurance (OASDI) program are available beginning in the 1960s, though projections for the year 2050 were already being made in the 1950s; 75-year projections for the Medicare Hospital Insurance Trust Fund began in 1983.

2. For a discussion of the 1990s emergence of budget surpluses, see Elmendorf, Liebman, and Wilcox (2002).

3. The 2011 Alternative Baseline comes from CBO (2011a) and assumes that the 2001/3 tax cuts are made permanent, other expiring tax provisions are extended, the alternative minimum tax is indexed for inflation, and Medicare's payment rates for physicians' services are held constant at their current level.

4. The line "Incorporating Recent Legislation" modifies the CBO May 2013 baseline (CBO 2013) by assuming that expiring tax provisions will be extended and that Medicare's payment rates for physicians' services are held constant at their current level. It does not assume that the automatic enforcement provisions from the BCA of 2011 will be repealed. Even if one thinks it likely that some of the "sequester" will be repealed, the CBO baseline also assumes that spending on military activities in Afghanistan will be maintained at current levels, which is unlikely if the troop draw-down occurs as scheduled. Thus, on net the aggregate CBO discretionary spending estimate may be a plausible assessment of spending under current policy.

5. CBO (2012a) tabulates the reasons why the actual surpluses from 2001 to 2011 differed from projections. Looking at the year 2007, there was a 5.3% of GDP deterioration in the budget outlook between the 2001 projection and actual experience; 43% of the deterioration came from a decline in revenue, with 80% of the revenue decline from legislative changes and 20% from economic and technical factors; 43% of the deterioration came from increased discretionary spending and 13% from increased mandatory spending. In calculating these percentages, I allocated increased interest on the debt in 2007 to each component of the budget according to that component's share of the cumulative deterioration in the budget outlook between 2001 and 2007.

6. See Auerbach et al. (2003) and Auerbach, Gale, and Orszag (2006) for earlier use of this approach.

7. CBO (2011a) projected interest rates on the 10-year Treasury note of 5.4% in 2021 under the alternative fiscal scenario, compared with 5.0% under its (lower-deficit) baseline scenario. Debt-to-GDP in 2021 would be 89.7% under the alternative fiscal scenario compared with 58.5% in the baseline scenario.

8. CBO (2011b) estimates that the cumulative deficit impact of automatic stabilizers (including forgone revenue) will total 12% of GDP between 2008 and 2016.

9. Coming up with a total budgetary cost of stimulus policies is challenging because it requires judgments such as whether to count the original projected cost of the Troubled Asset Relief Program or the final cost and whether to count the annual tax extenders that were included in ARRA. A plausible upper-bound estimate is that policy actions have added 10% of GDP to the debt. However, these calculations ignore any feedback between the stimulus policies and economic output. DeLong and Summers (2012) show that in severely depressed economies in which interest rates are constrained by the zero lower bound, temporary fiscal expansions may actually be self-financing.

10. Owing to the ARRA, there was a temporary 26% spike in discretionary budget authority in 2009.

11. Elmendorf et al. (2002) discuss another example in which unrealistic budget caps were ignored. The Gramm-Rudman-Hollings deficit reduction law of 1985 set explicit annual deficit targets that declined to zero over several years, but it did not specify the policy actions to achieve the deficit reduction. When the target proved too difficult to meet in 1987, the targets were raised.

12. The Bowles-Simpson plan also raises tax rates on income from capital.

13. The historic forecast errors in the Office of Management and Budget estimates include those coming from legislative changes as well as those from economic shocks and technical modeling factors.

14. Over the past 3 years, Ryan has released new versions of his plan, no longer supported by Rivlin, in which the vouchers would grow more slowly. The newer versions would accomplish additional deficit reduction while shifting more health care costs to seniors.

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