



APRÈS BUSH, LE DÉLUGE?

ALAN J. AUERBACH AND WILLIAM G. GALE

“**H**ow did you go bankrupt?” Bill asked.
“Two ways,” Mike said.
“Gradually and then suddenly.”

—Ernest Hemingway, *The Sun Also Rises*

At the end of the Reagan Administration, large and ongoing budget deficits left many observers wondering about the sustainability of U.S. fiscal policy and caused one of us to

Alan J. Auerbach is Robert D. Burch Professor of Economics and Law and Director of the Burch Center for Tax Policy and Public Finance at the University of California, Berkeley. William G. Gale is Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and Co-Director of the Urban-Brookings Tax Policy Center. This paper is an abbreviated version of Auerbach and Gale (2009).

© The Berkeley Electronic Press

ask “Après Reagan, le Déluge?” in the *Journal of Monetary Economics*. The U.S. fiscal picture recovered dramatically during the 1990s, however, as a result of sustained budget discipline, a prolonged economic expansion, and a sharp decline in military spending as the Cold War ended.

Indeed, by 2000, the U.S. fiscal picture was bright. The federal budget hit a record surplus of 2.4 percent of GDP. The Congressional Budget Office (2001) projected rising surpluses, totaling \$5.6 trillion over the succeeding 10 years. Even if one looked out over the next 70 years, despite projected shortfalls in Medicare and Social Security, government finances were in manageable shape as we explained in the *National Tax Journal* in 2000. A key fiscal concern was the prospect of paying off all redeemable public debt, which

was expected to occur by the middle of the decade.

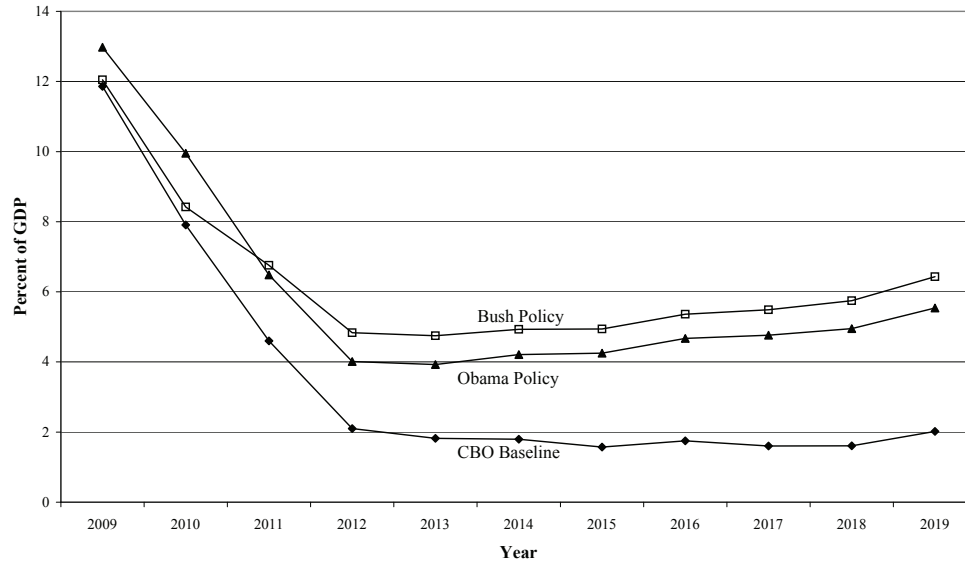
In the decade since 2000, however, the fiscal recovery of the 1990s has been completely undone by economic weakness and fiscal irresponsibility. Further, the unfunded shortfalls of old-age entitlement programs now loom two decades closer than they did at the end of the Reagan Administration, making even a repeat of the remarkable 1990s experience inadequate for fiscal recovery.

RECENT EVENTS

The CBO projects the 2009 deficit to be \$1.7 trillion, which is about 12 percent of GDP. This represents the largest deficit share of the economy since World War II. In 2009, the U.S. federal deficit will be larger than the entire GDP of all but six other countries. Why so large?

The Economists' Voice www.bepress.com/ev July 2009

Figure 1
Alternative Deficit Projections, 2009–2019



Source: CBO (2009), Authors' Calculations.

A double whammy: Revenues will be at their lowest share of GDP since 1950, and spending at its highest share since 1945. The deficit would be even larger but for record-low interest rates, which have substantially reduced federal net interest payments. Note finally that the unprecedented scale and scope of financial interventions by the Treasury Department and the

that occurred from 2001 to 2008 was primarily the result of policy—tax cuts and spending increases. The sudden, sharp decline that occurred from 2008 to 2009 was primarily the result of the economic downturn and the induced policy interventions. Even if the economy were at full employment and none of the recent financial interventions or stimulus packages were

Federal Reserve Board raise concerns that the deficit is under-measuring the government's increasing liabilities.

Like Mike's bankruptcy in *The Sun Also Rises*, the collapse of the budget happened both gradually and suddenly. The gradual, but sizable, decline

enacted, the deficit would have been almost 4 percent of GDP, according to the CBO (2009), indicating a significant fiscal imbalance inherited from the previous Administration.

THE TEN-YEAR OUTLOOK

The CBO baseline projects that, following record deficits in 2009, the cumulative deficit for 2010–2019 will be \$4.4 trillion, with deficits declining sharply to 2 percent of GDP by 2012 and remaining flat through 2019 (see Figure 1). CBO's baseline, however, is simply a mechanical projection of current law. It takes no account of the likely extension of temporary policies and it makes stark assumptions about future discretionary spending, which is not technically covered by current law. As a result, it shows what would happen if Congress almost literally did nothing for a decade, but it does not indicate the implications of the recurrence of recent policy choices.

To measure the path fiscal policy was on as of the early months of the Obama Administration, after the passage of the stimulus package, we adjust the CBO baseline assumptions to represent the continuation of the policies enacted under former President Bush. Under

what we will call the “Bush-policy” budget (although it is not literally Bush policy, since it includes the stimulus package), the ten-year deficit is \$10.1 trillion, or 5.7 percent of GDP. As in CBO’s baseline, deficits decline in the near term, but only to 4.8 percent of GDP by 2012, and unlike in CBO’s baseline, deficits then rise, to 6.4 percent of GDP by 2019.

Under the policies laid out in the Obama Administration’s recent budget, the figures are only somewhat better, with the ten-year deficit projected to be \$9.1 trillion. The annual deficit declines to 4.0 percent of GDP by 2012, but rises again to 5.5 percent of GDP by 2019, although the economy is projected by then to have been at full employment for several years. Spending under the Administration’s budget rises to 24.5 percent of GDP (the highest since World War II, except for the current downturn), and the debt-to-GDP ratio rises to 82 percent (the highest since 1948) by 2019.

Under either Bush policy or Obama policy, the deficit figures are poised to rise further as a share of GDP after 2019, implying that the situation is unsustainable.

Budget projections are uncertain, of course, but they should not be ignored. It is hard to

paint an optimistic picture of the current situation. Indeed, these budget figures are based on assumptions that appear optimistic. So far, the economy has performed worse than assumed in the projections. The estimates also make strong political assumptions: that major components of the stimulus package will be allowed to expire as scheduled and that, for the next ten years at least, Congress imposes and abides by “PAYGO” rules—the budget-control restrictions in place during the 1990s but jettisoned during the past decade of fiscal excess. Moreover, even if PAYGO is adopted as proposed, it will not help much. PAYGO rules are not structured to control autonomous growth of existing entitlement programs like Medicare. And, as proposed by the Administration, the PAYGO rules would also exempt major new unfunded initiatives to cover extensions of the 2001 and 2003 income and estate tax cuts, fixes for the alternative minimum tax, and extensions of higher Medicare physician payments.

THE LONG-TERM OUTLOOK

We estimate a long-term fiscal gap of about 4–6 percent of GDP under the assumptions in the CBO baseline as illustrated in

Table 1. By a fiscal gap we mean an immediate and permanent tax increase or spending cut of this amount would be needed to keep the long-term debt-GDP ratio at its current level. Under the Bush-policy budget or the Obama-policy budget, the gap is about 7–9 percent of GDP, and the debt-to-GDP ratio would pass its 1946 high of 108.6 percent around 2025 with no change in policy; unfortunately, our projections after 2025 have the debt-to-GDP ratio continuing to rise, contrary to its sharp decline after 1946.

It will prove difficult to close the gap entirely via modifications to existing taxes and spending programs, but close it, we must. A new revenue source, such as a value added tax (VAT), may be needed. A VAT at a rate of between 15 percent and 20 percent would generate sufficient revenue to close the fiscal gap under the Administration’s budget (The second of us described how much revenue could be raised by a VAT in a 2005 piece in *Tax Notes*).

Projected growth in Medicare and Medicaid creates a rising spending/GDP profile over time (Figure 2) and is the single largest component of the fiscal gap. Under the projections using

Table 1
Fiscal Gaps

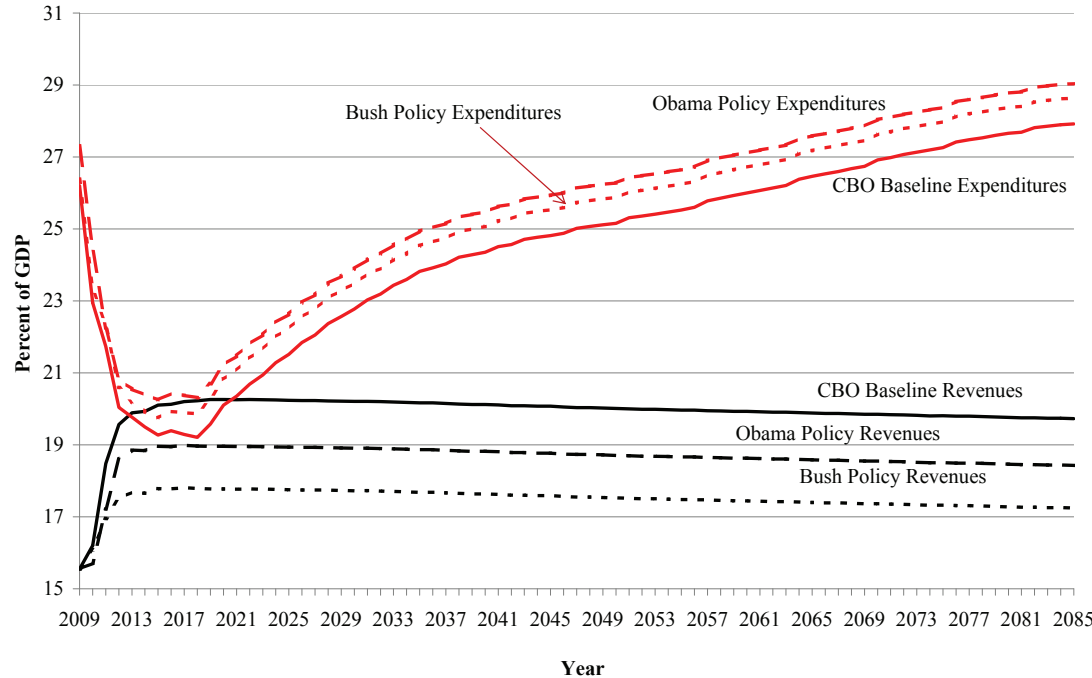
Baseline:	CBO Baseline		Adjusted Baseline		Administration Budget	
	Through 2085	Permanent	Through 2085	Permanent	Through 2085	Permanent
As a percent of GDP	4.46	6.28	7.49	9.39	6.80	8.65
In trillions of present-value dollars	34.1	90.7	57.3	135.7	52.0	125.1
1.5 percentage point reduction in health spending growth per year for 10 years						
As a percent of GDP					5.57	7.14
In trillions of present-value dollars					42.6	103.2
1.5 percentage point reduction in health spending growth per year for 30 years						
As a percent of GDP					3.96	4.90
In trillions of present-value dollars					30.3	70.8
1.5 percentage point reduction in health spending growth per year for 75 years						
As a percent of GDP					2.90	2.49
In trillions of present-value dollars					22.2	35.9
3.0 percentage point reduction in health spending growth per year for 75 years						
As a percent of GDP					0.92	0.00
In trillions of present-value dollars					7.0	0.0

Source: Authors' Calculations.

the Administration's baseline, cutting the annual growth rate of health spending by 1.5 percentage points for 10 years would reduce the long-term fiscal gap by 1.5 percent of GDP, but the gap would still remain above 7 percent of GDP. The same growth rate reduction for 30 years would reduce the gap by almost 4 percent of GDP, but would still leave the fiscal gap at almost 5 percent of GDP. To eliminate the long-term gap through reductions in health spending growth alone, the growth rate of spending on Medicare and Medicaid would need to be reduced by 3 percentage points annually over the next 75 years. That is, expenditures currently projected to grow at a rate nearly 2.5 percent points *faster* than GDP during the next ten years would instead have to begin *falling immediately* as a share of GDP.

Rising health care costs, though, are not necessarily "the" cause of the fiscal gap. The gap has been increased by more than 5 percentage points of GDP just by continuation of the policies enacted during the Bush Administration. The main culprits here are extensions of the Bush

Figure 2
Revenues and Non-Interest Expenditures as a Percent of GDP



Source: CBO (2009), Authors' Calculations.

tax cuts and Alternative Minimum Tax adjustments, and defense and other spending. The Medicare Part D provisions enacted in 2003 figure into both the health care cost and the Bush policy costs.

FISCAL ISSUES AND PROSPECTS

The deteriorating budget outlook has not been missed by the markets. The price of purchasing insurance against default on 5-year senior U.S. Treasury debt rose from around 10

basis points before September 2008 to above 90 basis points in early 2009 before falling back to 30 basis points by early May. Under the assumption (used in the Bloomberg data set from which this series is drawn) that if defaults occur, bond holders would recover 40 percent of par value, the implied default probabilities rose from under 1 percent to almost 8 percent in February, before declining to 3 percent.¹ These figures do not reflect our own views of the current creditworthiness of the U.S., but others are at least implicitly seeing an increase in the likelihood of explicit default on U.S. Treasury bonds, a notion that was virtually unthinkable in the past. And, note that these figures relate to default *in the next five years*, not to long-term liabilities, which do seem to us to be increasing in risk. Perhaps the increase in spreads in the fall and winter could be attributed to the financial panic during that time, but a recent uptick for June is harder to explain along those lines.

In March, the Chinese Prime Minister Wen Jiabao publicly questioned the security of U.S. Treasury bonds. In May, the Medicare Trustees projected that the Trust Fund would be exhausted by 2017. Also in May, Standard

and Poor's Ratings Service warned the U. K. that it may lose its triple-A credit rating due to projected debt-to-GDP ratios. This is sobering for the United States as well, which has a similar debt-to-GDP trajectory. Could the United States face a similar threat of downgrade? Perhaps the dollar's *de facto* status as the world reserve currency prevents that outcome, but as the Harvard economist Benjamin Friedman argued two decades ago a country's status as the reserve currency issuer may depend on its fiscal health. Thus, while the United States' special issuer status has helped in the current downturn by allowing large monetary and fiscal expansions, the possible U.K. downgrade suggests that both this status and the U.S. credit rating may be in jeopardy.

The U.K. warning is also an example of a broader trend—namely, that the U.S. federal government is not alone in its fiscal troubles. Most European countries will experience significant fiscal deterioration over the next few years. At home, the individual states face daunting fiscal prospects.

Over the next several years, as the recession ends and the economy recovers, policy

makers will face a delicate balancing act between encouraging economic recovery and establishing fiscal sustainability. While short-term fiscal stimulus can boost an otherwise slack economy, persistent deficits in a full-employment economy will have deleterious effects on national saving and national income. As a result, fiscal discipline imposed too soon could weaken the recovery or push the economy back into recession, as it did during the Great Depression according to Christina Romer. Fiscal discipline delayed too long could also harm the economy, either gradually, as higher interest rates reduce economic activity and deficits sap national saving, or suddenly, if investor fears trigger a sharp and adverse market response as explained by Larry Ball and Greg Mankiw and more recently by Robert Rubin, Peter Orszag and Allen Sinai.

The balancing act will be made more difficult by a host of factors, including: the fiscal difficulties faced by the states and European countries; the fact that both political parties have announced opposition to tax increases; the reality that the vast bulk of spending occurs in areas that will be difficult to cut in the

short term, including Social Security, Medicare, Medicaid, defense, and net interest; and the potential populist backlash that could inhibit effective policy making if financial markets, which tend to lead the economy, recover while labor markets take a long time to regain full employment and wage growth.

THE FUTURE IS NOW AND IF NOT NOW SOON

Hillel said “if not now, when.” Although serious observers of U.S. fiscal policy have long understood that the country faced a long-term fiscal problem, policy makers have largely failed to act, even though delays only make the required policy response more difficult for the economy. Now, however, huge short-term deficits and unsustainable medium-term plans have accelerated the need to address these issues, and capital market disruptions have reduced the likelihood that growing U.S. fiscal imbalances will be tolerated.

This said, we are cautioned by Christina Romer's studies of the Great Depression against recommending a reduction in the huge short-term deficits intended to keep the current recession from dipping further downward. Once the economy recovers, though, the need

to impose fiscal discipline will become urgent and require difficult choices. Ben Bernanke's job would be easier if Congress and the Administration could send some clear signal now that they will be up to this task.

Letters commenting on this piece or others may be submitted at <http://www.bepress.com/cgi/submit.cgi?context=ev>.

NOTES

1. Probability-of-default calculations are done in Bloomberg using the JPMorgan model for credit default swap valuation. This model backs out the implied probability of default from the market price, or spread on the CDS, given the assumed recovery rate of 40 percent.

REFERENCES AND FURTHER READING

- Auerbach**, Alan J. (1989) "Après Reagan, le Déluge?: A Review Article," *Journal of Monetary Economics*, 24(2): 299–311. September.
- Auerbach**, Alan J. and William G. Gale (2009) "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond an Update," Brookings. Available at: http://www.brookings.edu/~media/Files/rc/papers/2009/06_fiscal_crisis_gale/06_fiscal_crisis_gale.pdf.
- Auerbach**, Alan J. and William G. Gale (2000) "Perspectives on the Budget Surplus," *National Tax Journal*. 53(3): 459–73. September.
- Ball**, Laurence and N. Gregory Mankiw (1995) "What Do Budget Deficits Do?" NBER Working Paper No. 5263. Available at: <http://www.nber.org/papers/w5263>.
- Congressional Budget Office** (2009) "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook." March. Available at: <http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf>.
- Congressional Budget Office** (2009) "An Analysis of the President's Budgetary Proposals for Fiscal Year 2010." June. Available at: http://www.cbo.gov/ftpdocs/102xx/doc10296/06-16-AnalysisPresBudget_forWeb.pdf.
- Congressional Budget Office** (2009) "Measuring the Effects of the Business Cycle on the Federal Budget." June. Available at: <http://www.cbo.gov/ftpdocs/102xx/doc10299/06-23-BusinessCycle.pdf>.
- Congressional Budget Office** (2001) "The Budget and Economic Outlook: Fiscal Years 2002–2011." January. Available at: <http://www.cbo.gov/ftpdocs/27xx/doc2727/entire-report.pdf>.
- Friedman**, Benjamin (1988) *Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After*. New York: Random House.
- Gale**, William G. (2005) "The National Retail Sales Tax: What Would the Rate Have To Be?" *Tax Notes*, 107(7): 889–911. May 16.
- Romer**, Christina D. (1992) "What Ended the Great Depression?" *The Journal of Economic History*, 52(4): 757–784. December. Available at: <http://www.fcs.edu.uy/multi/phes/Romer%201992.pdf>.
- Robert** E. Rubin, Peter R. Orszag and Allen Sinai (2004) "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray." Paper presented at the AEA-NAEFA Joint Session, January 4. Available at: http://www.brookings.edu/papers/2004/0105budgetdeficit_orszag.aspx.

