C. Eugene Steuerle

Commentary

To tell the tale of recent fiscal policy, one must relate it to the recent past. The postwar period to about 1974 was an era of easy financing. Not only was economic growth high, it far exceeded the expectations conditioned partly on the Depression experience. But economic growth told only a small part of the story. Domestic policy actions were financed by an extraordinary shift out of defense—from about 14 percent of GDP in 1953 to 5.5 percent in 1974 and to about 3 percent today. This shift—most of which had occurred by the end of the Vietnam War—in today's economy produces about $1 trillion that can be spent on domestic programs without any increase in tax rates. Inflation led to significant bracket creep in the income tax and, as it accelerated, it made real interest rates on government debt very low. Social Security tax rates were also rising with little notice, partly because most retirees until today—rich and poor alike—paid net negative tax rates when their increasing levels of benefits were compared with their tax liabilities.

All of these factors led to extraordinary growth in the rate of domestic spending—so high that more than half of all this country's domestic spending growth (as a percentage of GDP) took place during the Eisenhower and Nixon presidencies alone (Steuerle and Mermin 1997). Moreover, the public was receiving legislative tax cuts at the same time.

Only gradually has the exceptional nature of this Era of Easy Finance, as I have labeled it, come to be recognized, long after its financing sources for domestic spending expansion began to wane. In the post-1974 period, defense declines as a percentage of GDP continued, but a moderate build-up in the early 1980s warned that they could not continue forever. Then the tax system was indexed for inflation. Meanwhile, the rate of inflation slowed, leading to high realized real interest rates. By the 1990s, we also entered the first postwar decade in which Social Security tax rates were not increased. Of course, economic growth also was slower. The easy spending/tax cutting days were coming to an end, and budget acts began to take gradual recognition of the new period.

While before 1982, almost every major budget act was either an expenditure increase or a tax cut, from 1982 until 1997, almost all major legislation was, *on net*, a tax increase or an expenditure cut.

The 1981 tax cuts were really old wine in a new bottle. In many ways, they duplicated the Kennedy tax cuts in substance and form. Only fiscal policy was fundamentally different. In the early 1960s, it did not matter whether the Keynesians were right or not. If right, surpluses would come in three years; if wrong, they would take five years or so to appear. However, in the early 1980s, it also did not matter whether the supply-siders were right or not. Even with a remarkable spurt in economic growth, the budget was still headed toward large future deficits.

What was different? In the earlier period—indeed, throughout all of the nation's history up until then as well—fiscal slack was scheduled for the indefinite future, and it would rise over time. In the later period, little fiscal slack was available,

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These comments are based in part on Steuerle et al. (1998). The views expressed are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

and it was declining rather than rising over time. If one looks closely at the Reagan cuts, especially in terms of revenues as a percentage of GDP, federal taxes by the mid-1980s were still as high as they were in the mid-1970s, right before inflation caused enormous bracket creep and large tax increases. Today, despite those cuts, average tax rates by some measures are at a peacetime high (primarily because a less even distribution of income has added to average tax rates indirectly through the progressive income tax).

None of this fully explains why fiscal slack has dried up. Even if all sources of easy financing are eliminated and the economy slows, real revenues still rise about as fast as GDP over time. This implies that the future would portend enormous slack between future revenues and *existing* levels of expenditures "as far as the eye could see."

This type of slack used to be available when revenues were compared with expenditures under current law, as well as with existing levels of expenditures. But since the former fiscal or budgetary slack is gone, something must be different. And it is! What is fundamentally different is the composition of expenditures under current law. The nation moved from a budget that was primarily discretionary to one that was primarily one of entitlements. Moreover, it was not just that money was now put into programs that were scheduled to last forever. Some programs were also scheduled to grow, even at rates faster than GDP, forever and ever. Is it any surprise, then, that budget crises started to arise, and are scheduled to reappear once the baby-boomers start to retire?

Now, when the growth rate of entitlements is, say, 2 percent per year higher than GDP, there is still a lot of slack when those programs represent only one-tenth of the budget. When they start to occupy more than half of the budget, however, they start to matter a great deal. Chart 1, for example, shows Social Security, Medicare, and Medicaid as a share of GDP over the past few decades and according to future projections.

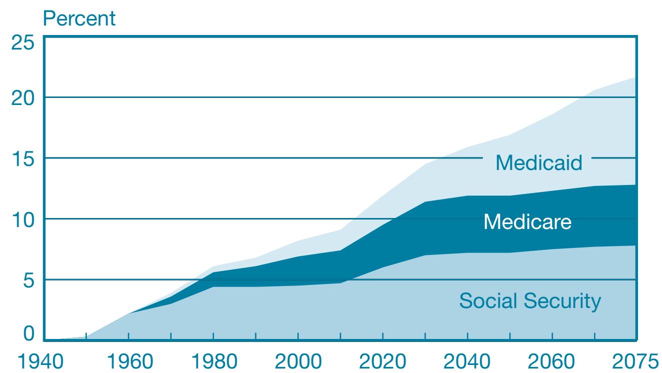
Never before in our history has so much been preordained in the budget even before the Congress votes on it. Imagine if at the Constitutional Convention our founding fathers had decided to set the entire expenditure budget for today. We would find that effort almost laughable. Yet that is exactly what we have done for the budget more than 200 years from now.

The reasons are not as complex as they might appear. In Social Security, the program is set up to grow forever faster than the economy because of the way it is indexed for wage growth and because it provides more and more years of benefits as we live longer. In many of the nation's health programs, access to new health goods and services is provided at no cost to the consumer, and the producer is in a position to bargain with the consumer over what the rest of society can be charged. Some think these problems are only an issue of demographics. Certainly, declining fertility and mortality lead to an aging of the population, exacerbating the potential budget crisis severely once the baby-boomers begin to retire, but the problem exists even without these additional demographic pressures. Most of the entitlements in question were designed around wants independently of the number of taxpayers who would be around to finance them. Thus, demographic factors simply bring to a head the difficulty of designing an expenditure program that has growth rates independent of the taxes available to pay for it.

Just how different this era is can be seen by ranking presidents by the growth in domestic spending as a percentage of GDP when they were in office (Steuerle and Mermin 1997). President Roosevelt ranks near to last. It was not merely that spending increased under Hoover more than most historians recognize or that World War II led to massive increases in defense spending. Most importantly, the majority of the spending increases under Roosevelt were always meant to be temporary, to meet the needs of the time. Thus, they were very different than the modern, large entitlement programs that are scheduled to grow in good times and bad alike. (Social Security itself was established under FDR, but it was much smaller in scope and did not have nearly as much growth built into its formulas.)

Go back further into the nation's history, and the same lesson applies. Almost all prior expenditure increases—for example, for the Louisiana Purchase, payments to war veterans, fighting the Depression—were temporary, no matter how large or grand they were at first.

Chart 1
Social Security, Medicare, and Medicaid as a Share of GDP



Source: Urban Institute. Based on the U.S. government budget, fiscal year 2000.

Alan Auerbach suggests in his paper that assumptions used to project future discretionary spending are unreasonable. He is right. These assumptions would have such spending falling toward zero as a percentage of GDP over time. Today, we are sitting in the eye of the storm. A temporary reprieve is granted while the ranks of the elderly are filled with the baby-bust generation of the Depression and World War II and the baby-boomers continue to represent a large share of the labor force. But future deficits are scheduled because of the entitlement spending growth of current law.

One final note. Fiscal policy is often considered an issue of how government is influencing the market for saving or investment. Similarly, economists love to try to demonstrate how they can solve almost any problem by tweaking (controlling) the market for saving and investment. However, we need to start changing our way of looking at macro or fiscal policy to take into account the human capital market as well.

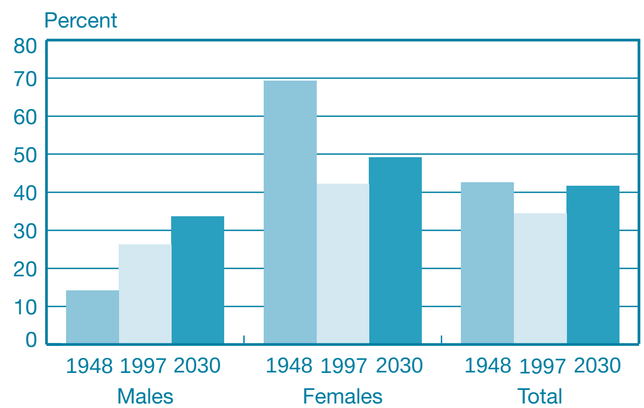
What I am suggesting is that barriers to labor were much less of a macro issue over the past few decades, but for reasons that will not continue. While federal policy was affecting the labor market greatly over the past twenty-five years, largely by subsidizing earlier and earlier retirement, there was one large mitigating factor. Despite the fact that men were dropping out of the labor market at very high rates as they sought more and more years in retirement, the entrance of women into the market in increasing numbers more than made up for the difference.

In Chart 2, I present a measure that I have developed and call the adult nonemployment rate (Steuerle and Spiro 1999). Over the postwar period, the nonemployment rate has gone down in almost every year other than a recession year. What this means, interestingly, is that over the past few decades, leisure—at least in aggregate—was not being demanded increasingly as the economy got richer. But our laws now schedule an increase in the nonemployment rate that is on the order of the labor market plunge of the Great Depression. Only this time the decline is scheduled to be permanent. On a year-to-year basis, the analogy would be with several small back-to-back recessions, one following the other for a period of more than twenty years. Thus, I believe that these labor market pressures are a macro as well as a micro issue, and that they could have serious effects on short-term as well as long-term fiscal policy if and when these labor market declines start.

Mind you, the rise in the nonemployment rate does not have to occur at the rate currently scheduled, although the retirement of the baby-boomers may make some part of this rise inevitable. Interactions with the labor demand side of the market will lead to shifts in employment that I do not believe are being anticipated well in most economic forecasting models. Nonetheless, freeing up older workers to respond to demand requires facing up to a whole series of dams in institutional government policy, and in some private retirement policy as well (Steuerle and Spiro 1999). Getting rid of only one or two dams may be an inadequate way to allow the water to flow. Thus, the traditional focus on saving (whether private or public) as the core element of macro policy may be seriously deficient in the presence of a structure that now assumes such large withdrawals from the work force.

Chart 2

The Adult Nonemployment Rate



Source: Urban Institute. Based on data from the U.S. Department of Labor, Bureau of Labor Statistics, and the U.S. Social Security Administration.

Note: The chart depicts those people age twenty or older who are unemployed or who are not in the labor force.

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