Balancing the U.S. Budget

Professor Kevin Mumford

August 6, 2012

Presentation Ground Rules

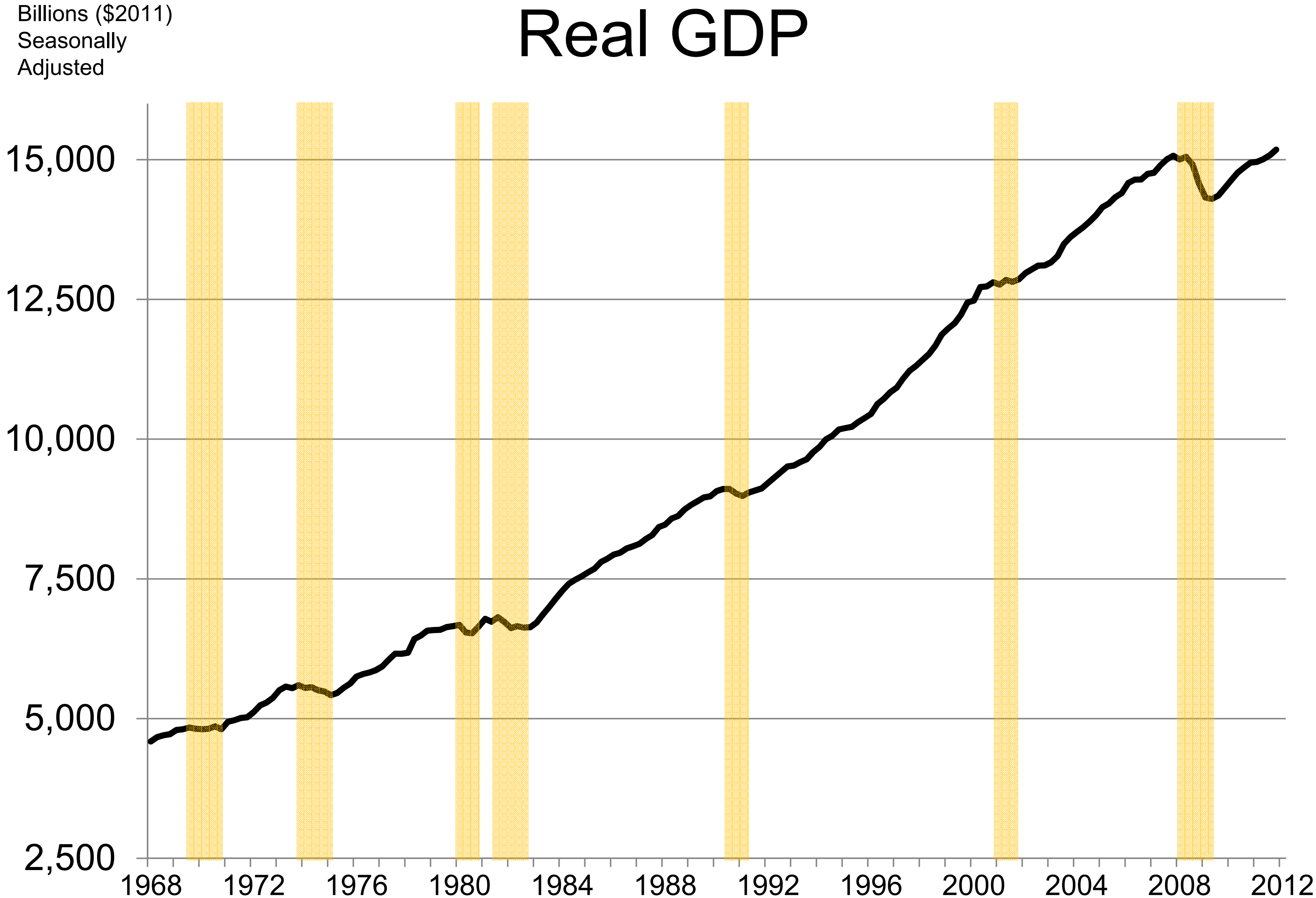
- No Normative Analysis
  - I will try to answer “what happened?” or “what would happen if … ?” questions
  - Normative questions like “what is fair?” or “what should the government do?” depend on values (i.e. social welfare function) and are considered out of bounds for this presentation.
- Ask Questions
  - We learn more from a good discussion than we do from a good lecture

Real GDP

GDP is the market value of all final goods and services produced in the U.S. in a year

Source: Bureau of Economic Analysis (U.S. Department of Commerce)

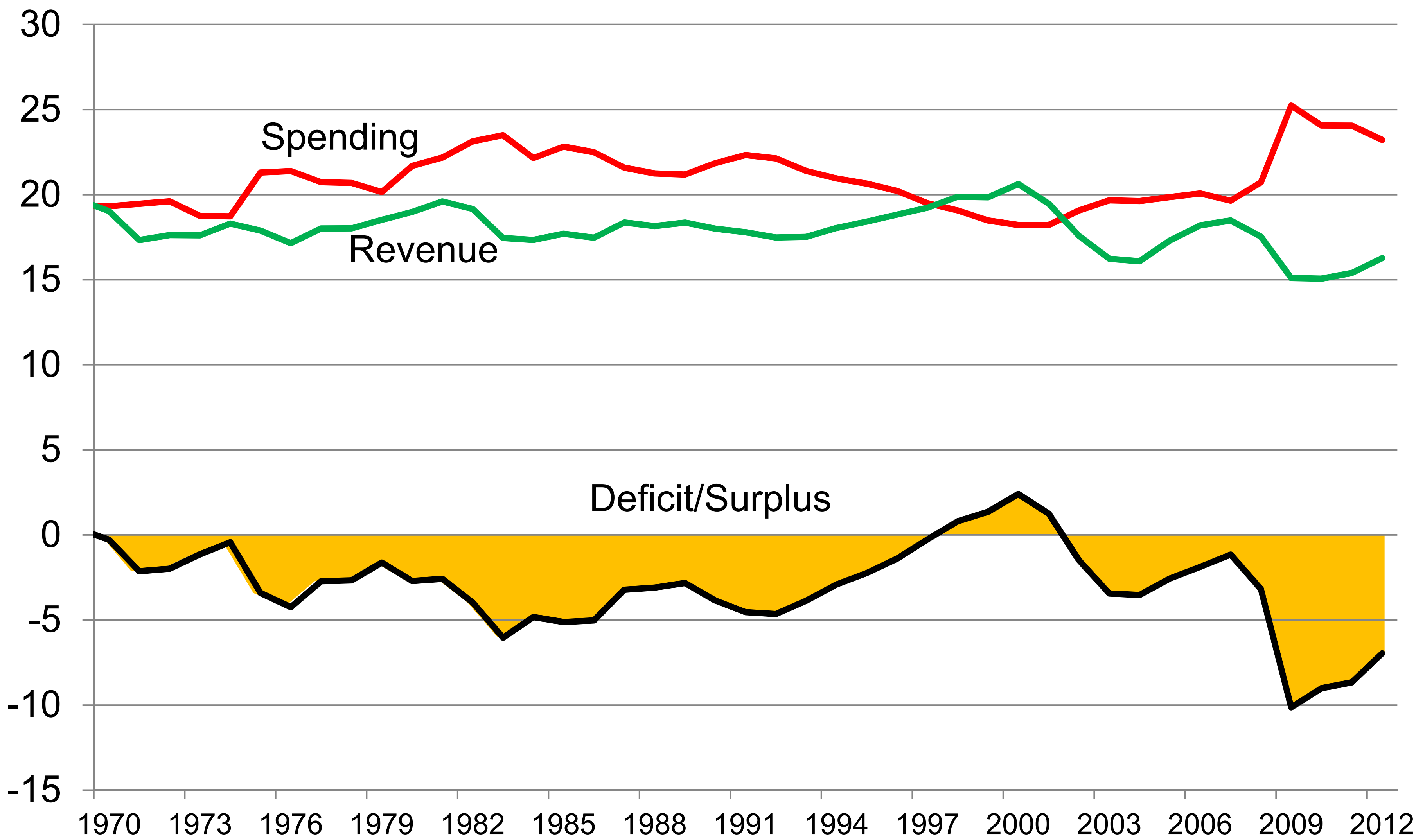
Real GDP



GDP is the market value of all final goods and services produced in the U.S. in a year

Source: Bureau of Economic Analysis (U.S. Department of Commerce), National Bureau of Economic Research

Federal Revenue and Expenditure as % of GDP



Source: US Congressional Budget Office (historical budget data)

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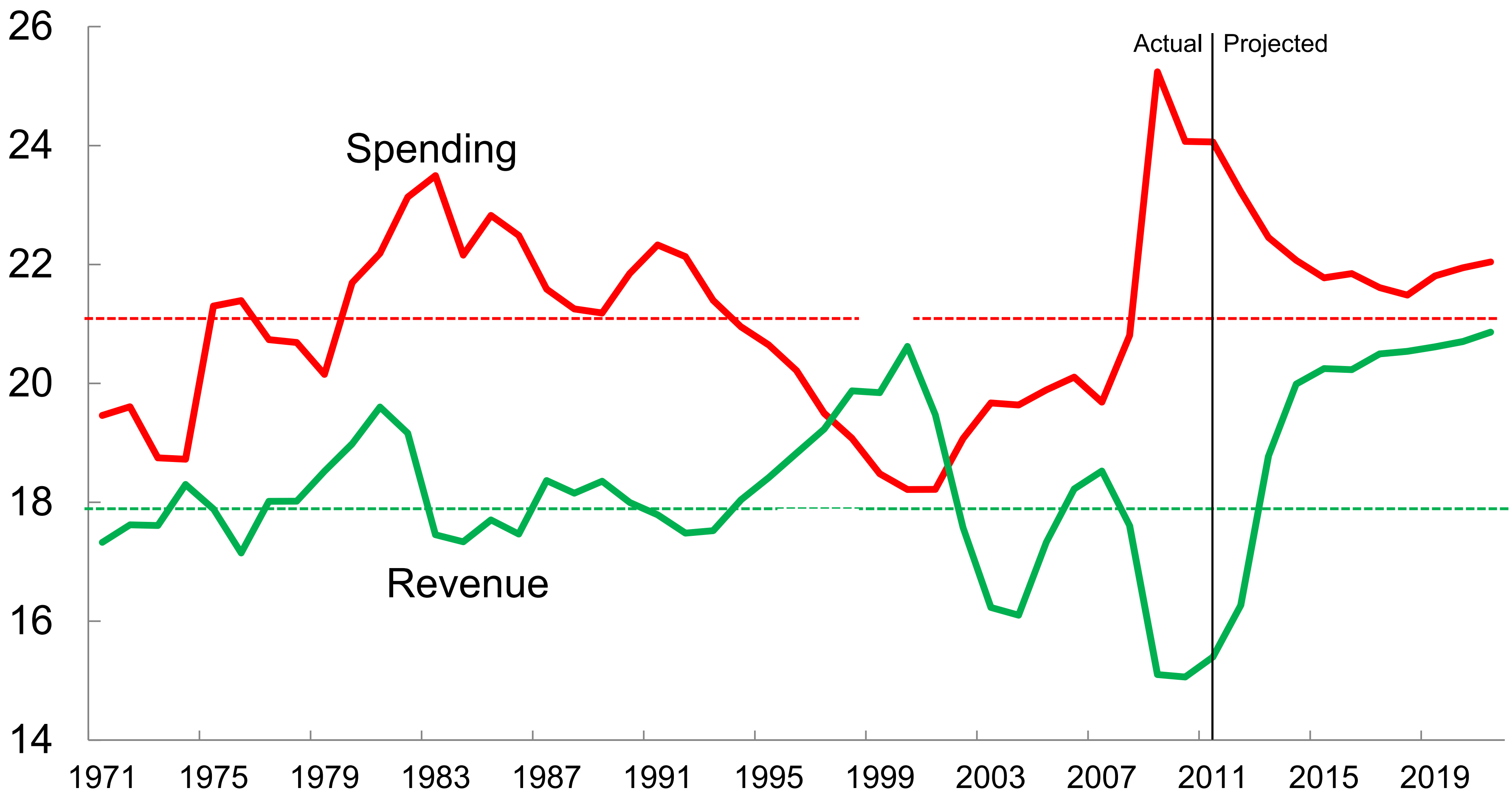


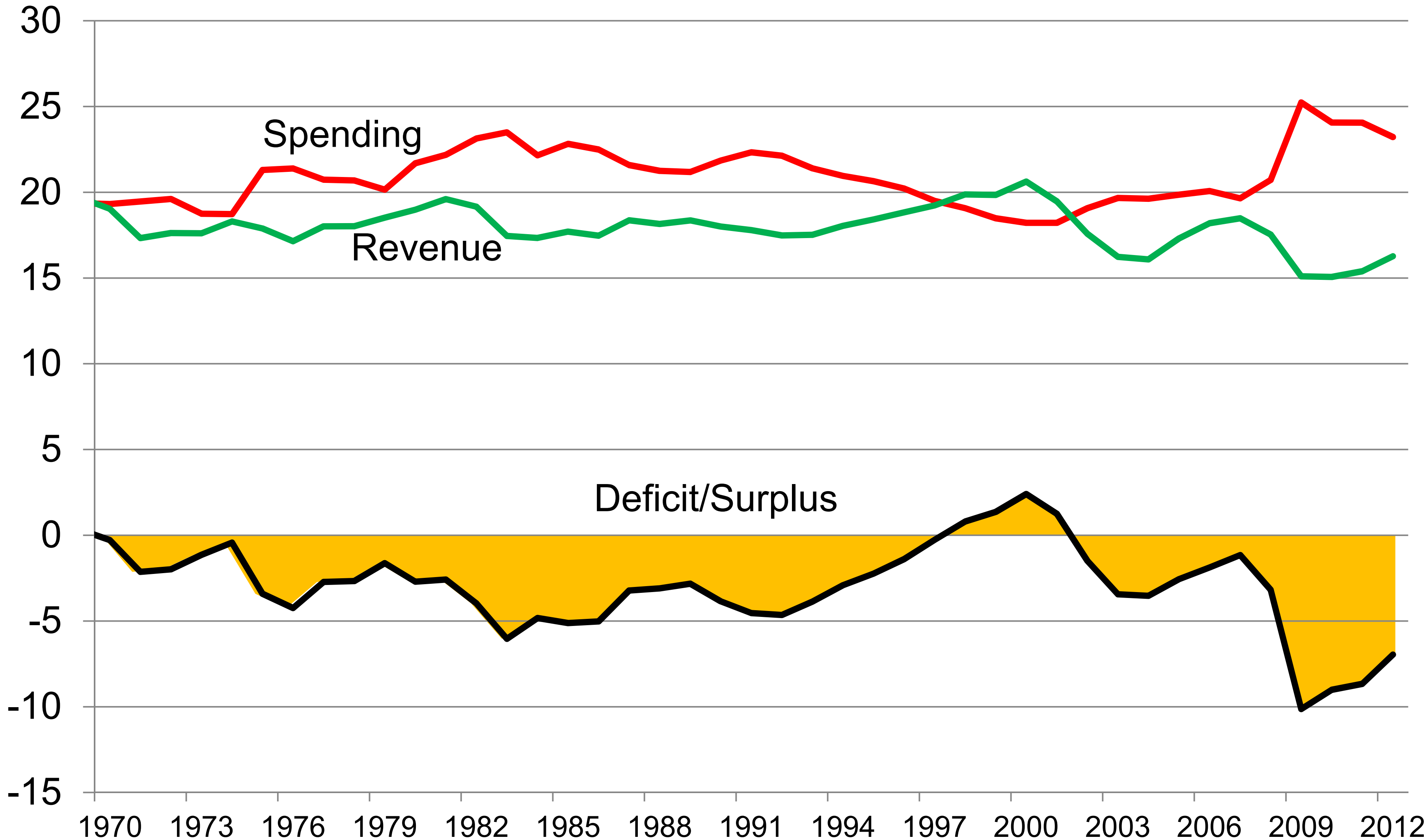
Source: US Congressional Budget Office (historical budget data) and (projections under current law)

Question: I balance my own budget, why can't the federal government?

Answer: the government is not like a household

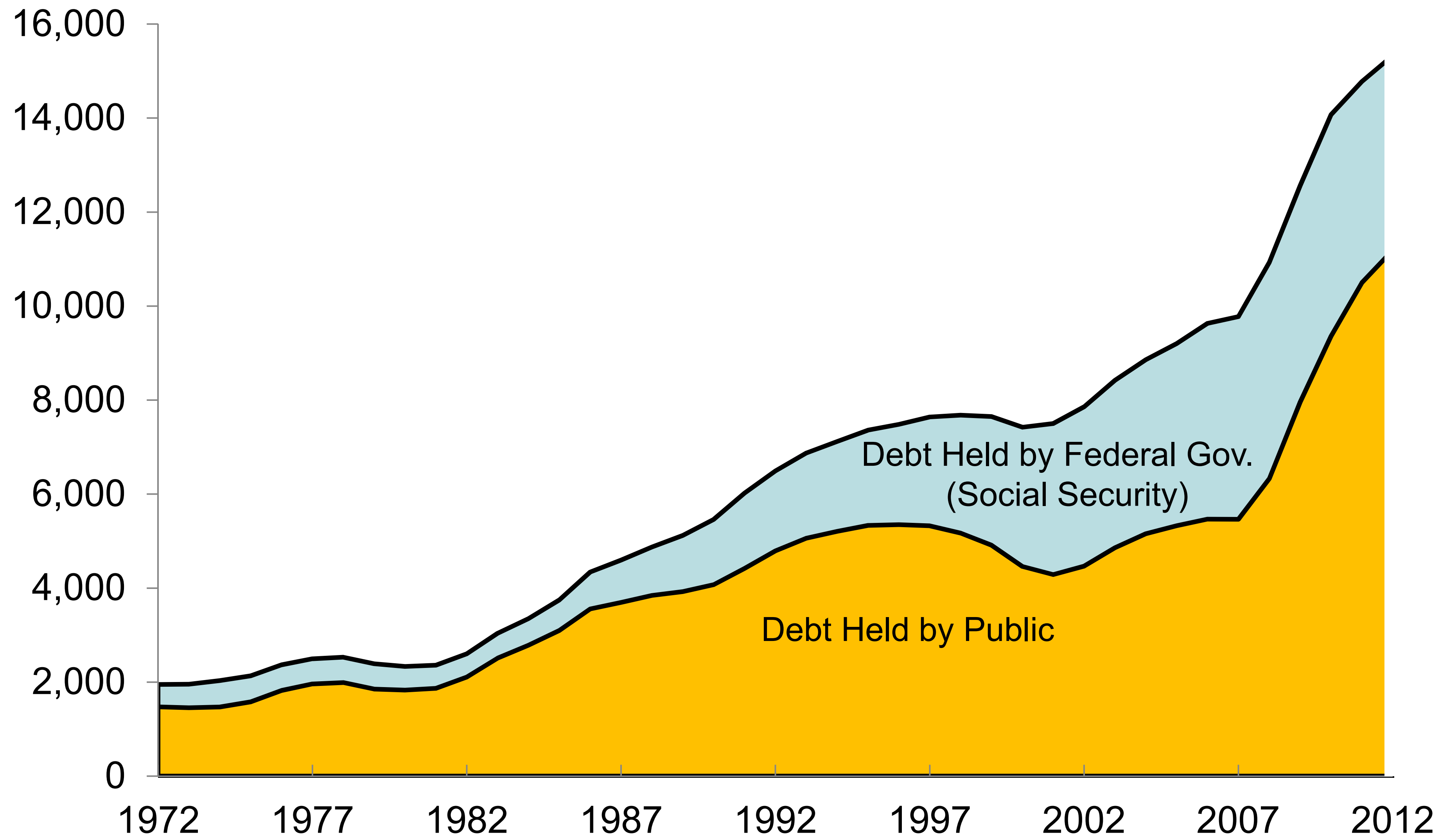
- Government is not going to retire (no need to save)
- Very low cost of borrowing (about 1% currently)
- A small deficit is very useful (financial markets)
- So, how large a deficit is OK?
  - This is a normative question!
  - It depends on the rate of economic growth
  - Economists get worried if the debt/GDP ratio increases

Federal Revenue and Expenditure as % of GDP



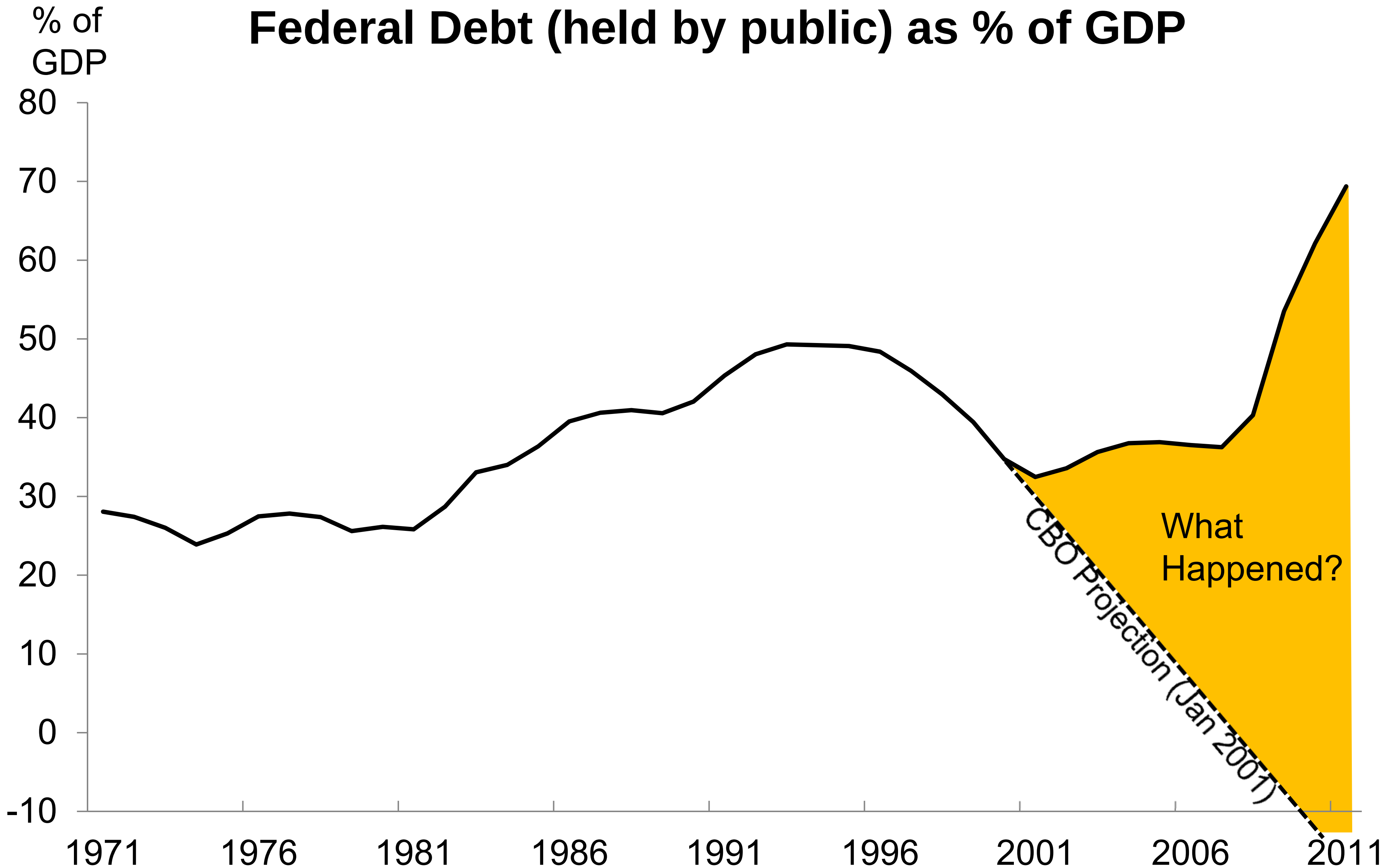
Source: US Congressional Budget Office (historical budget data)

Real Federal Government Debt



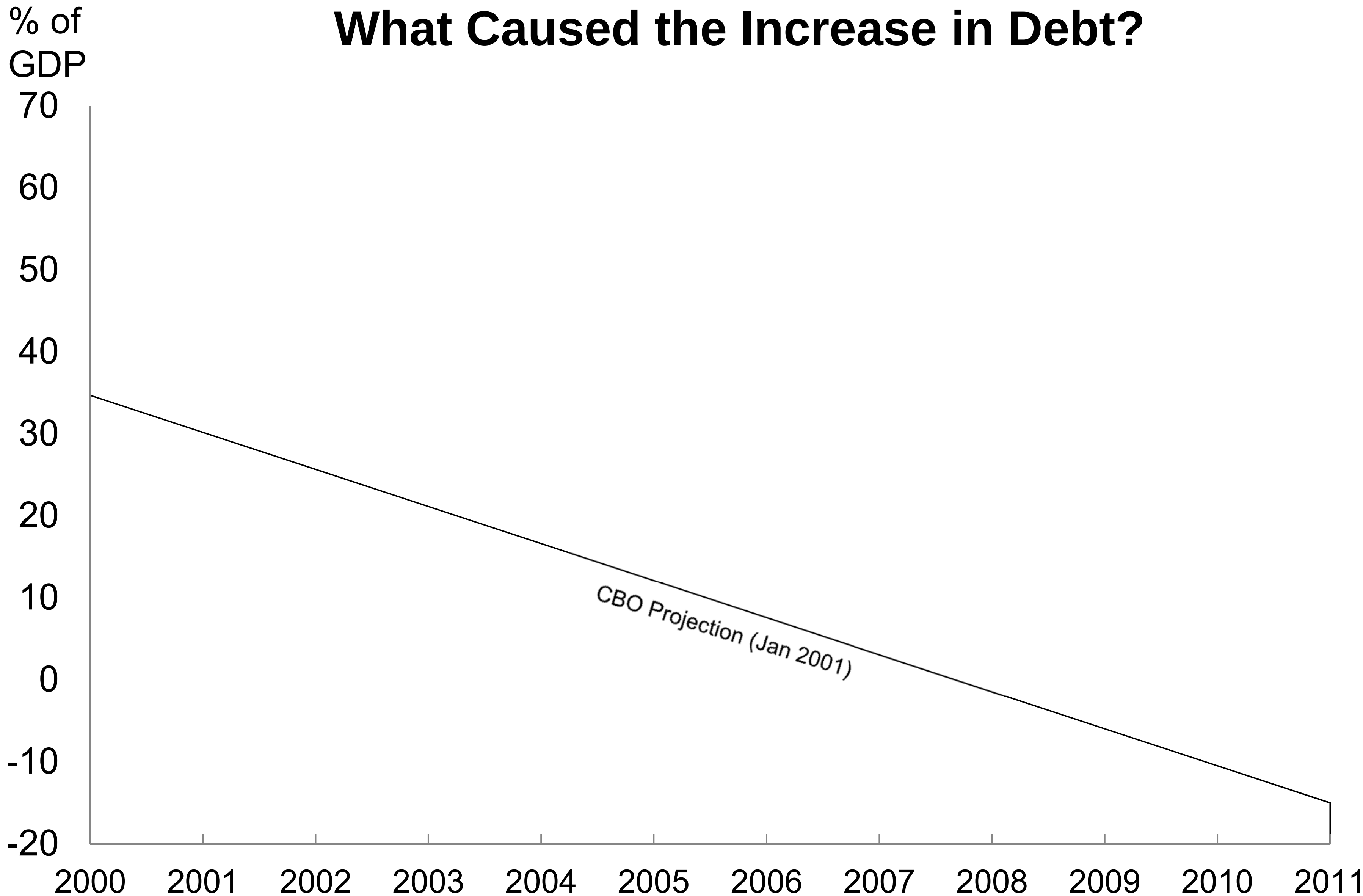
Source: US Congressional Budget Office (historical budget data), Dollars are in Billions of $2011

Federal Debt (held by public) as % of GDP



Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)

What Caused the Increase in Debt?



Source: US Congressional Budget Office (historical budget data) and (projection of federal debt); Pew Fiscal Analysis Initiative

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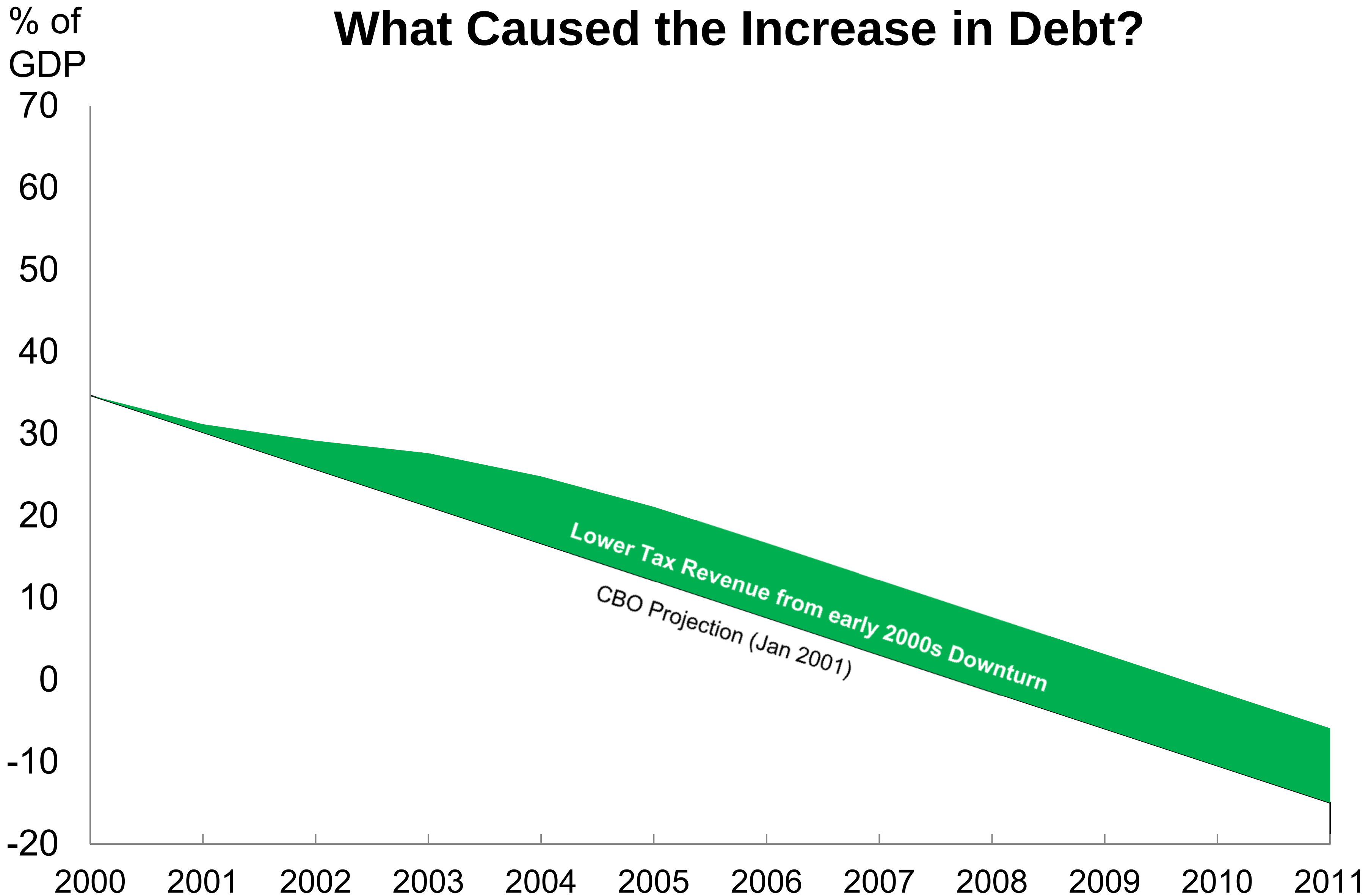

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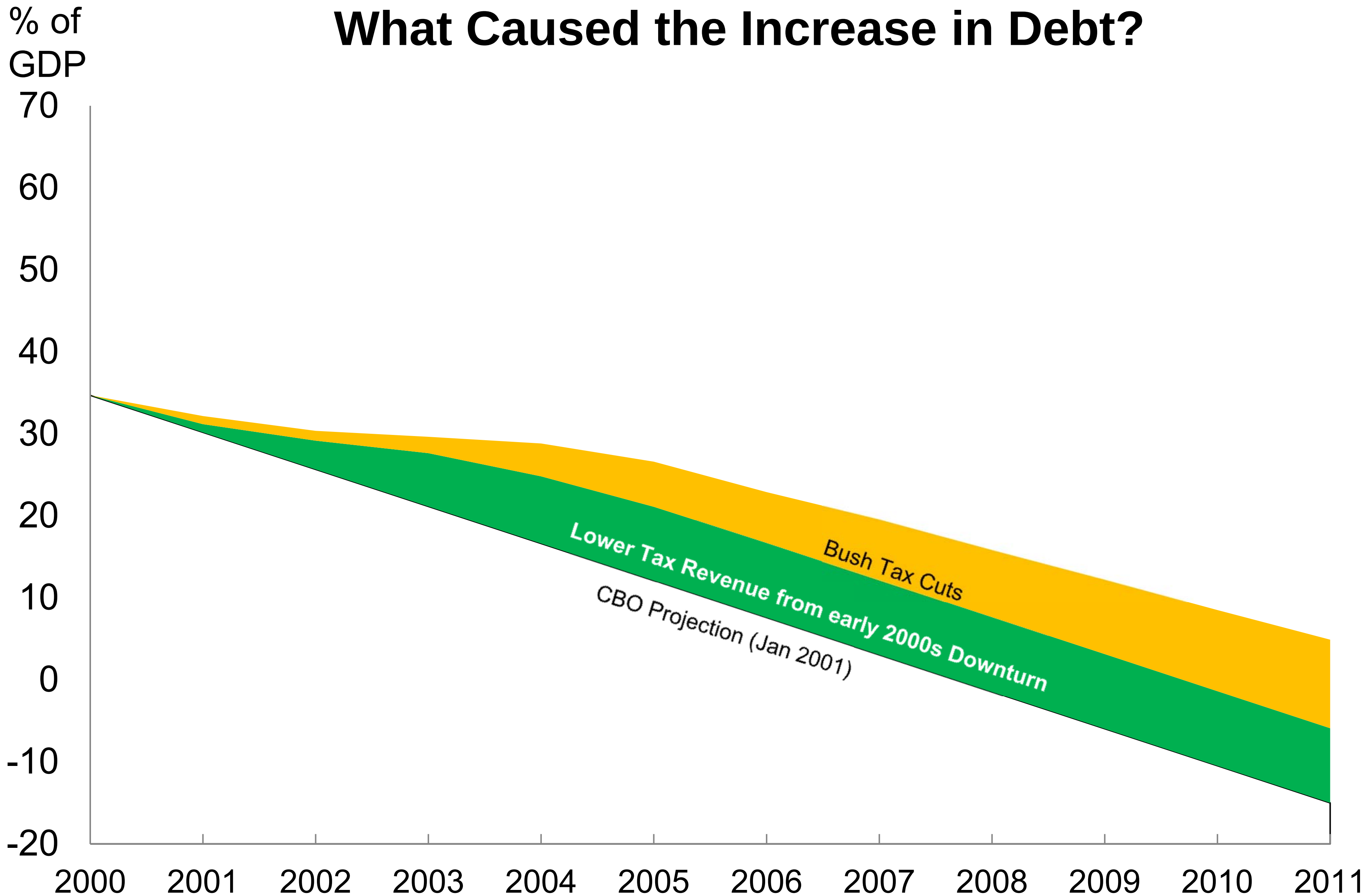

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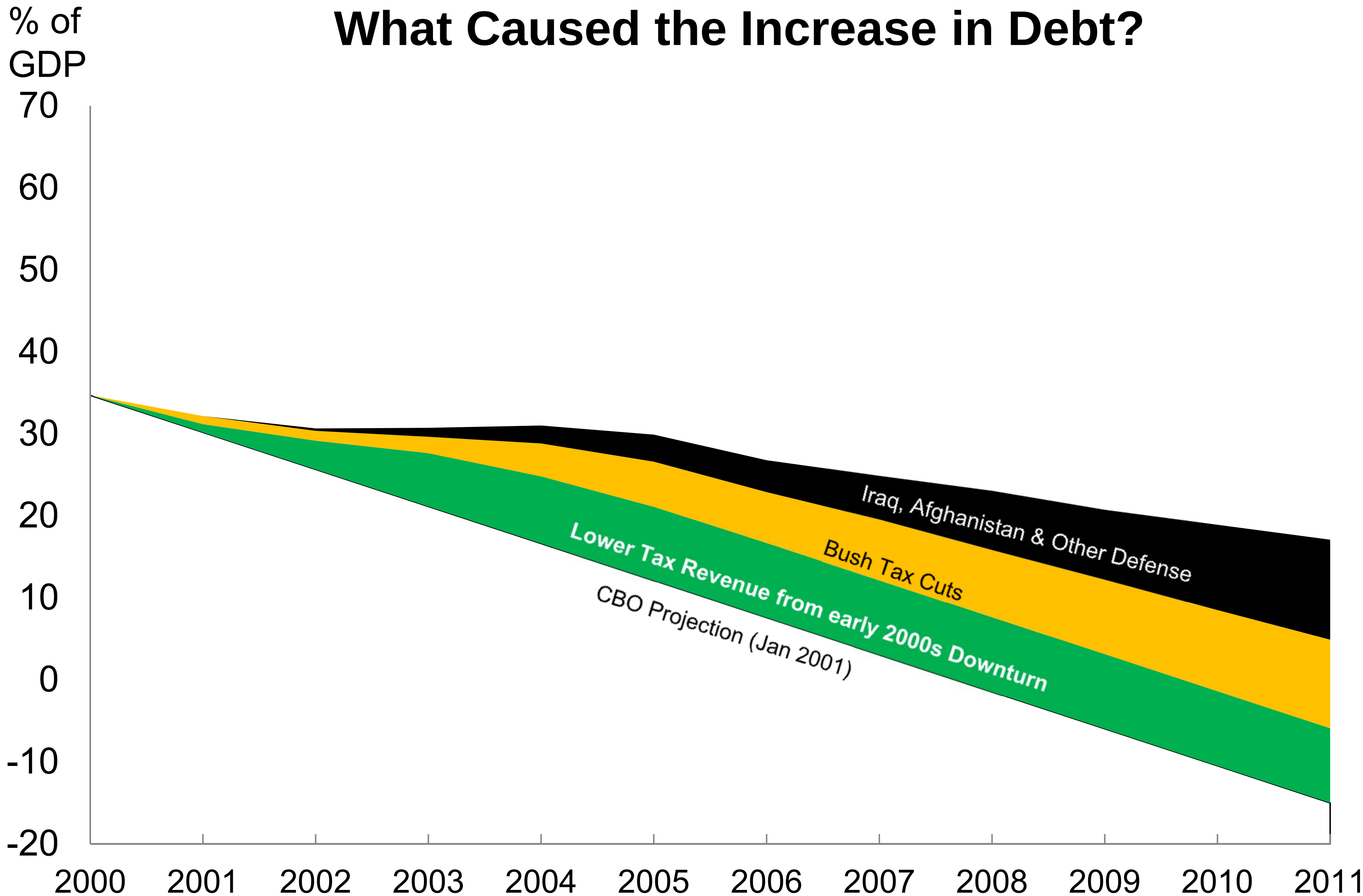

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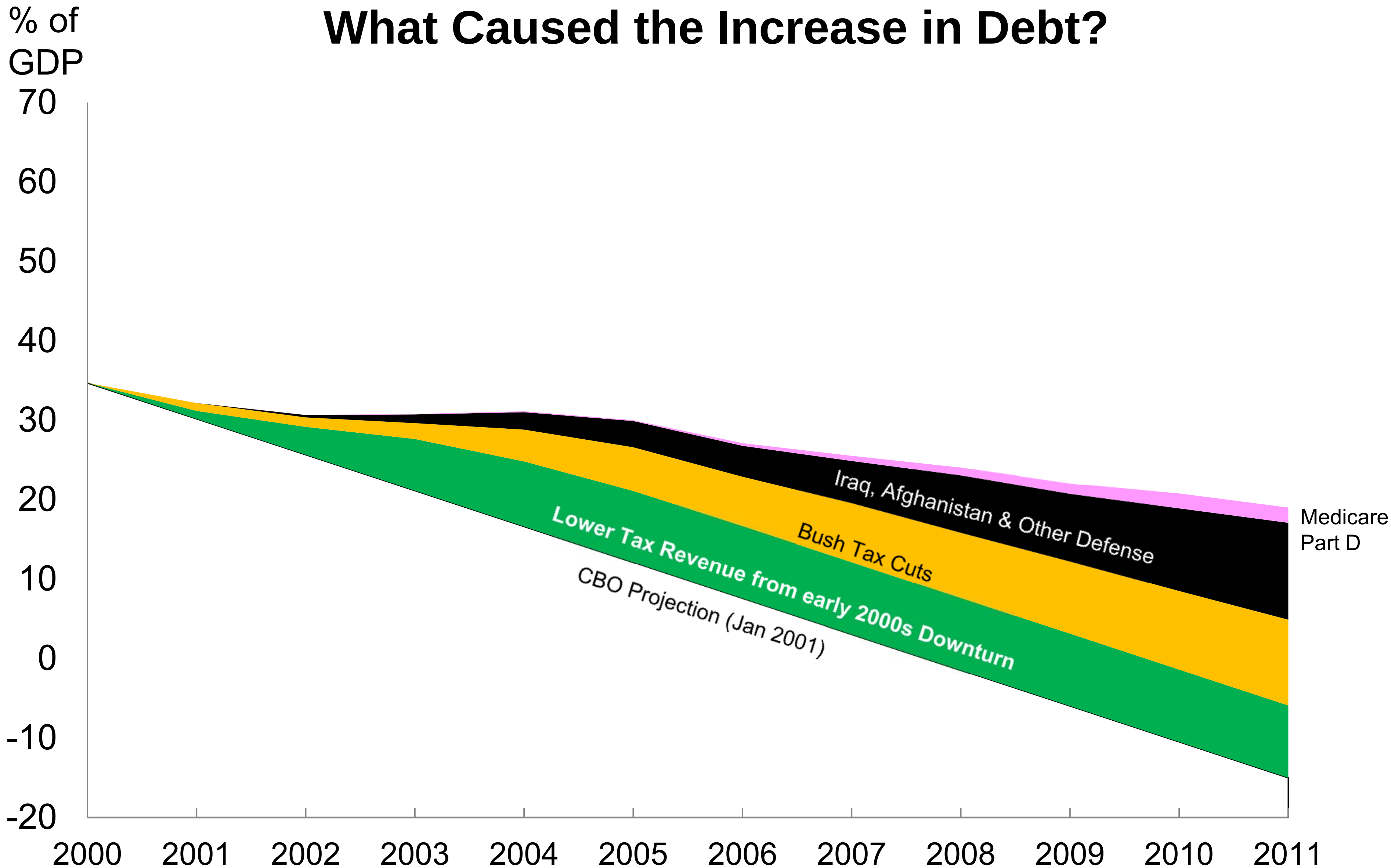

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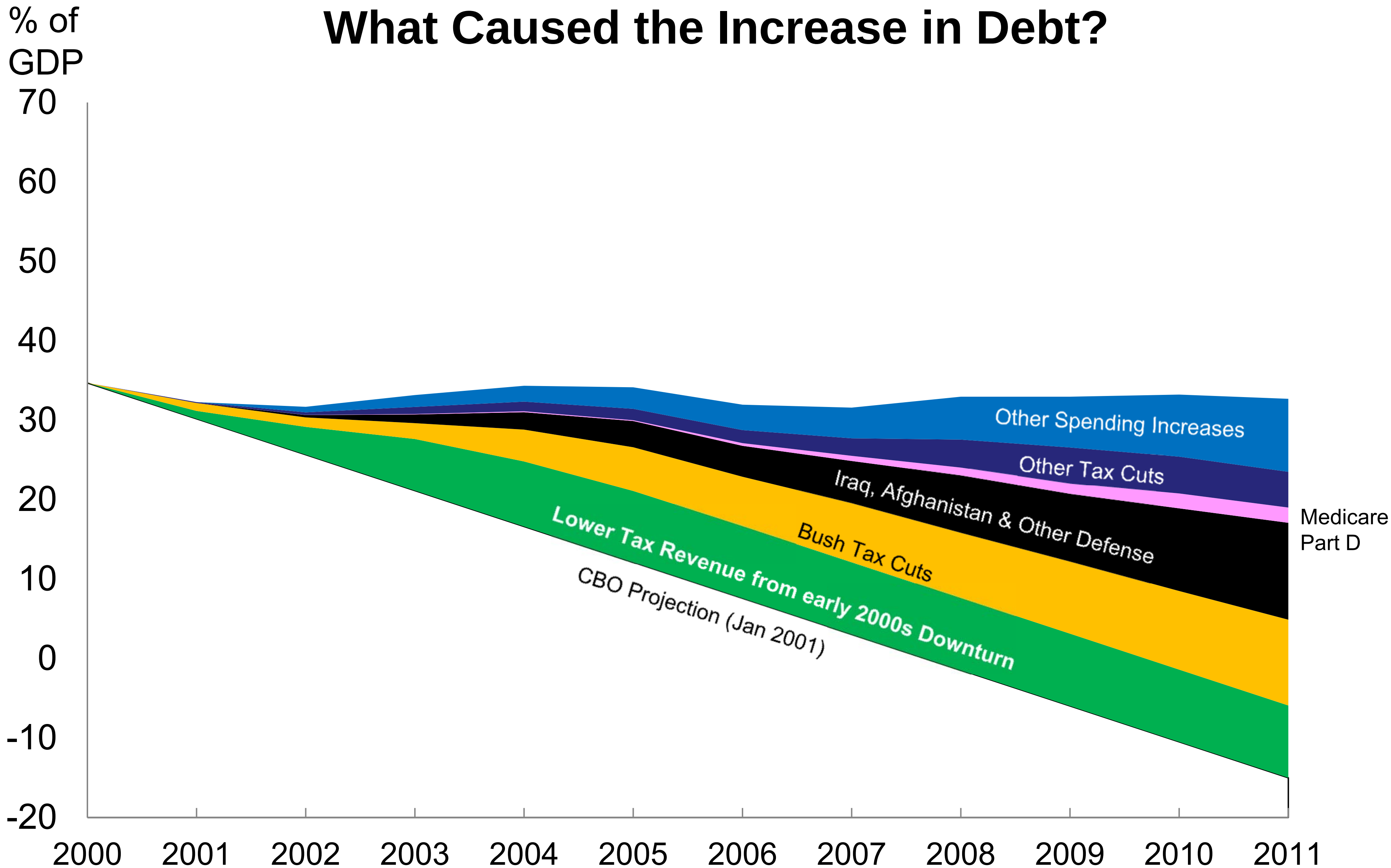

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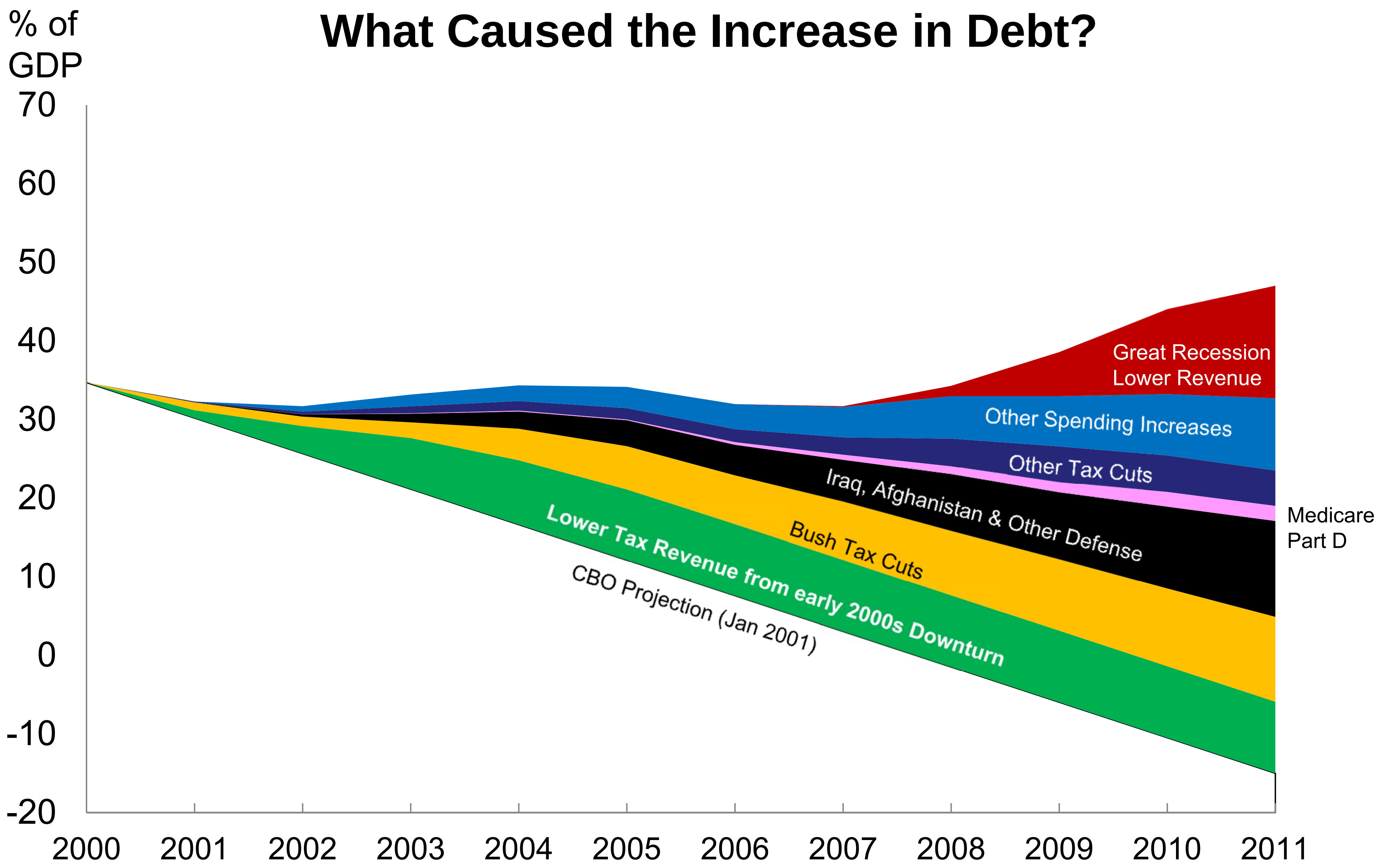

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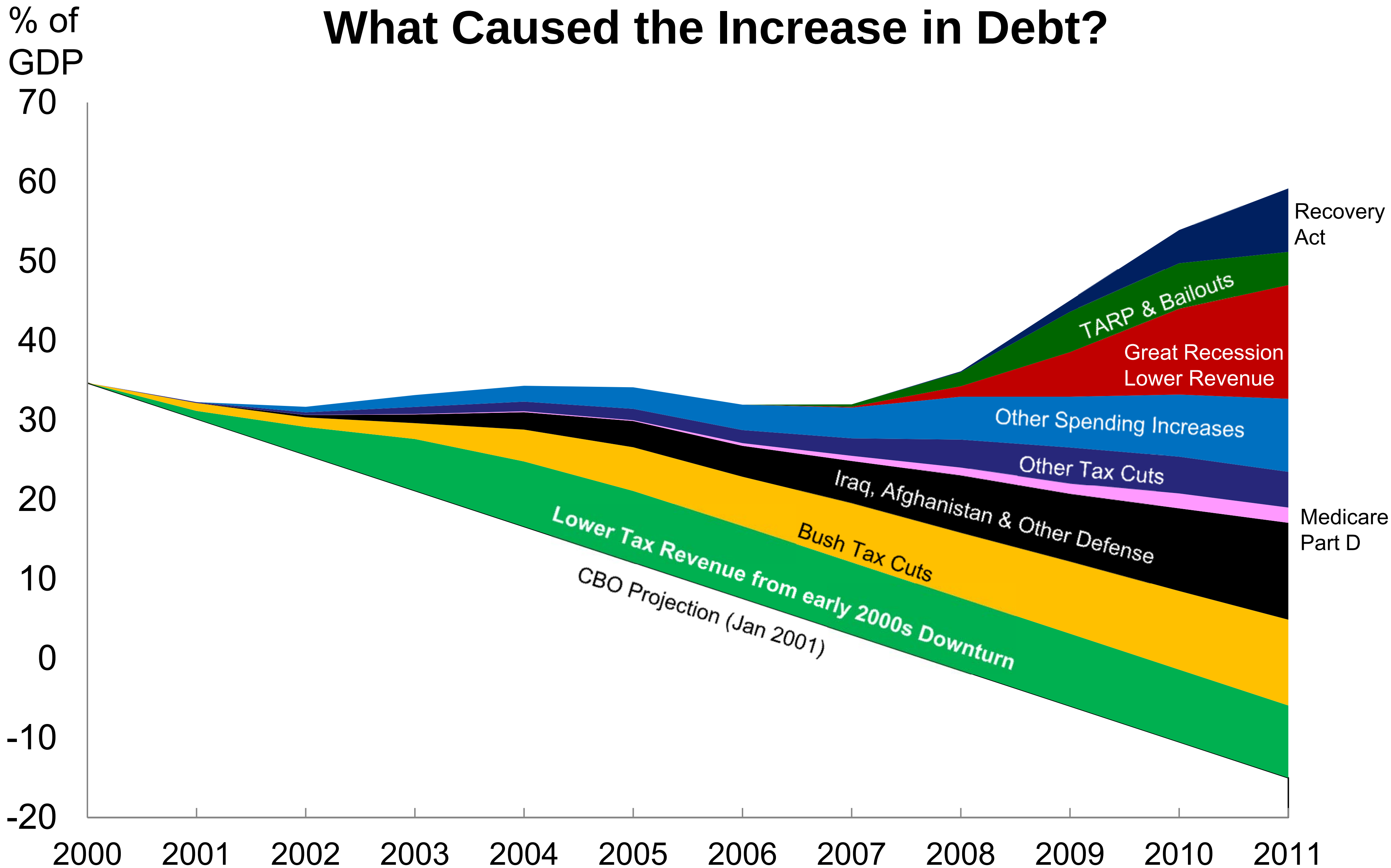

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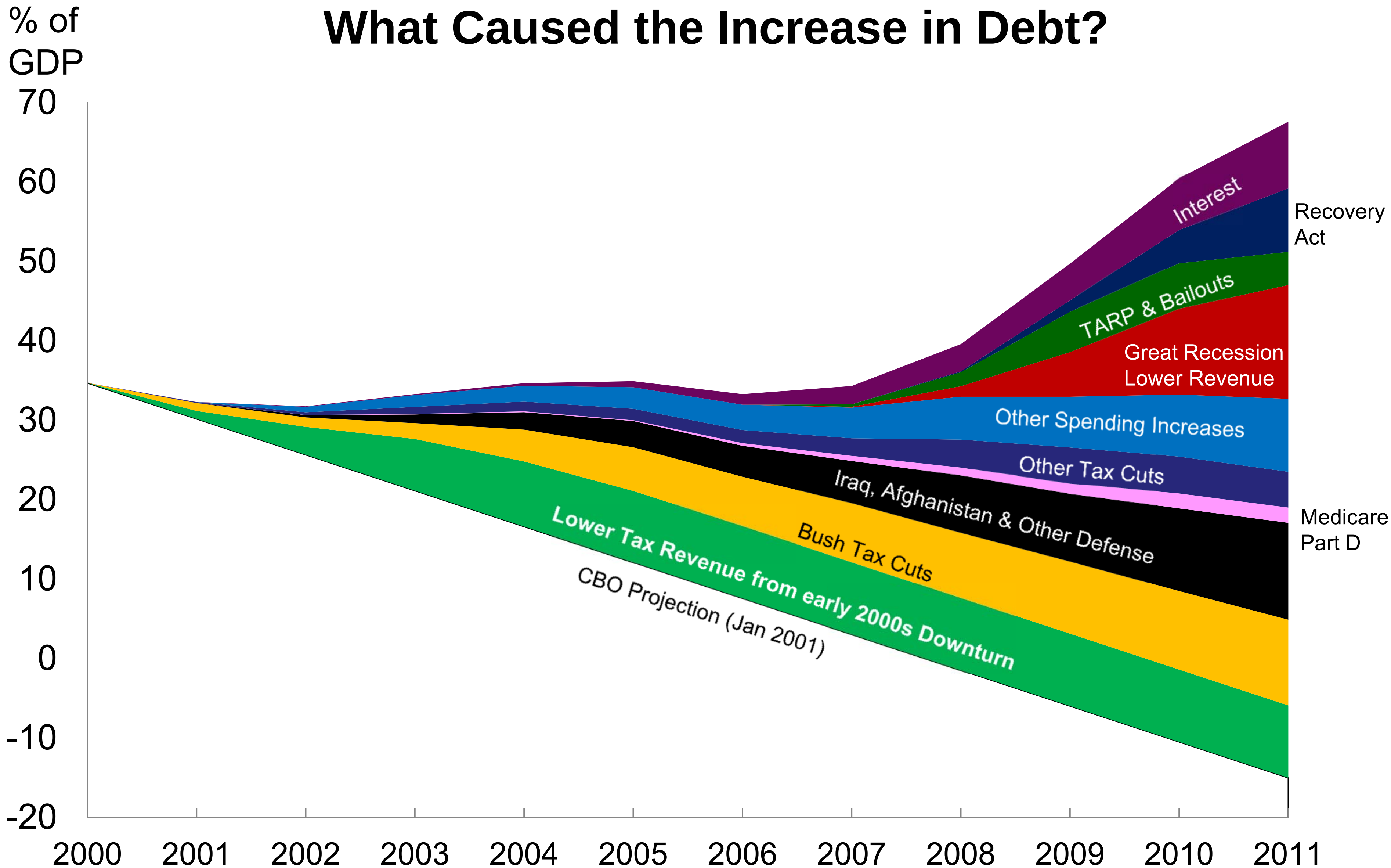


Source: US Congressional Budget Office (historical budget data) and (projection of federal debt); Pew Fiscal Analysis Initiative

What Caused the Increase in Debt?

- 31% Recessions (less income than expected)
- 29% New Tax Cuts (stimulus)
- 20% Spending (more than expected + new)
- 17% Defense Spending (more than expected)
- 3% Bailouts, TARP, loan guarantees, etc.

Question: What Do Budget Deficits Do?

What would change if the federal government had a 1% deficit rather than a 3.5% deficit?

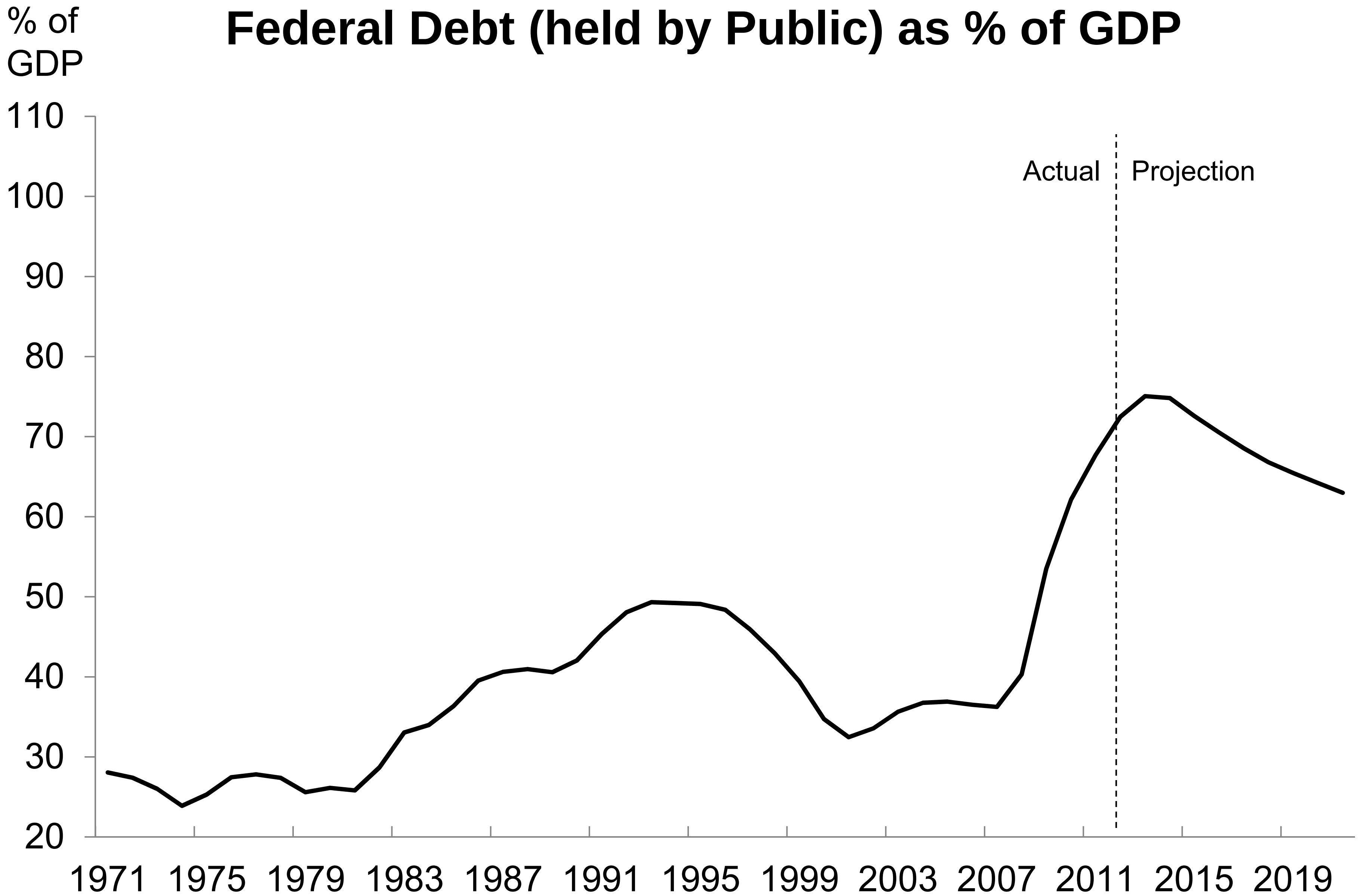
Standard Macro Model

- Lower deficit → higher investment and net exports
- Over the long run (30 years)
  - higher wages
  - lower return on capital (lower profits)
  - higher GDP growth rate
  - future lower tax rates
- Magnitudes depend on how the deficit was reduced (higher taxes or lower spending)

CBO Federal Debt Projection

- Federal debt is projected to grow to 75% of GDP by 2014 (was 35% from 2000-2007)

Federal Debt (held by Public) as % of GDP



Source: US Congressional Budget Office (historical budget data) and (projection of federal debt)

CBO Federal Debt Projection

- Federal debt is projected to grow to 75% of GDP by 2014 (was 35% from 2000-2007)
- This projection assumes current law will be left unchanged:
  - Bush Tax Cuts and AMT patch expire Dec 31, 2012
  - Dividend and capital gains tax rates go up on Dec 31, 2012
  - UI benefits reduced on Dec 31, 2012
  - Estate Tax rate increases to 55% in 2013
  - Budget Control Act ($2.1 trillion in spending cuts) happens

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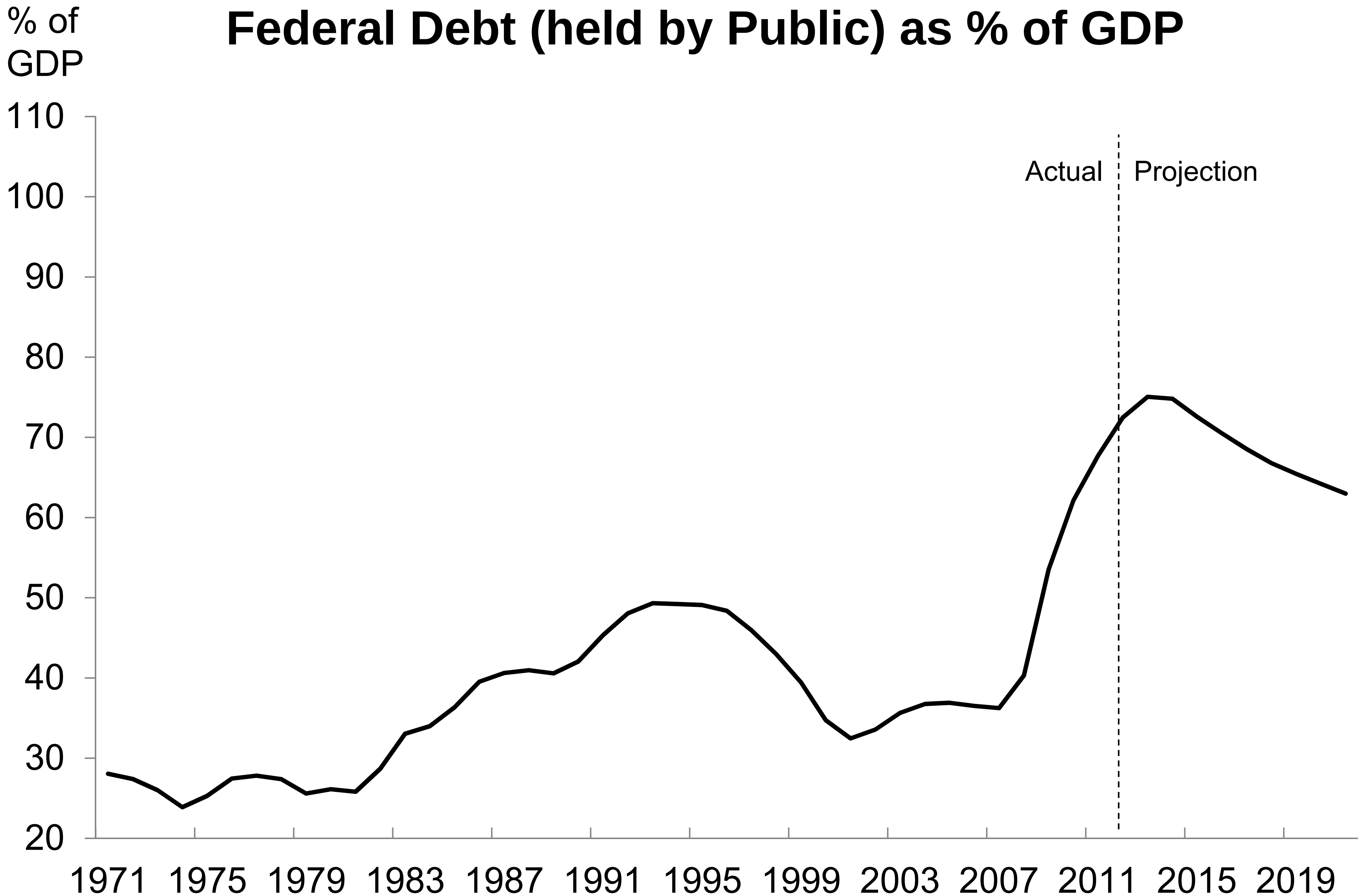

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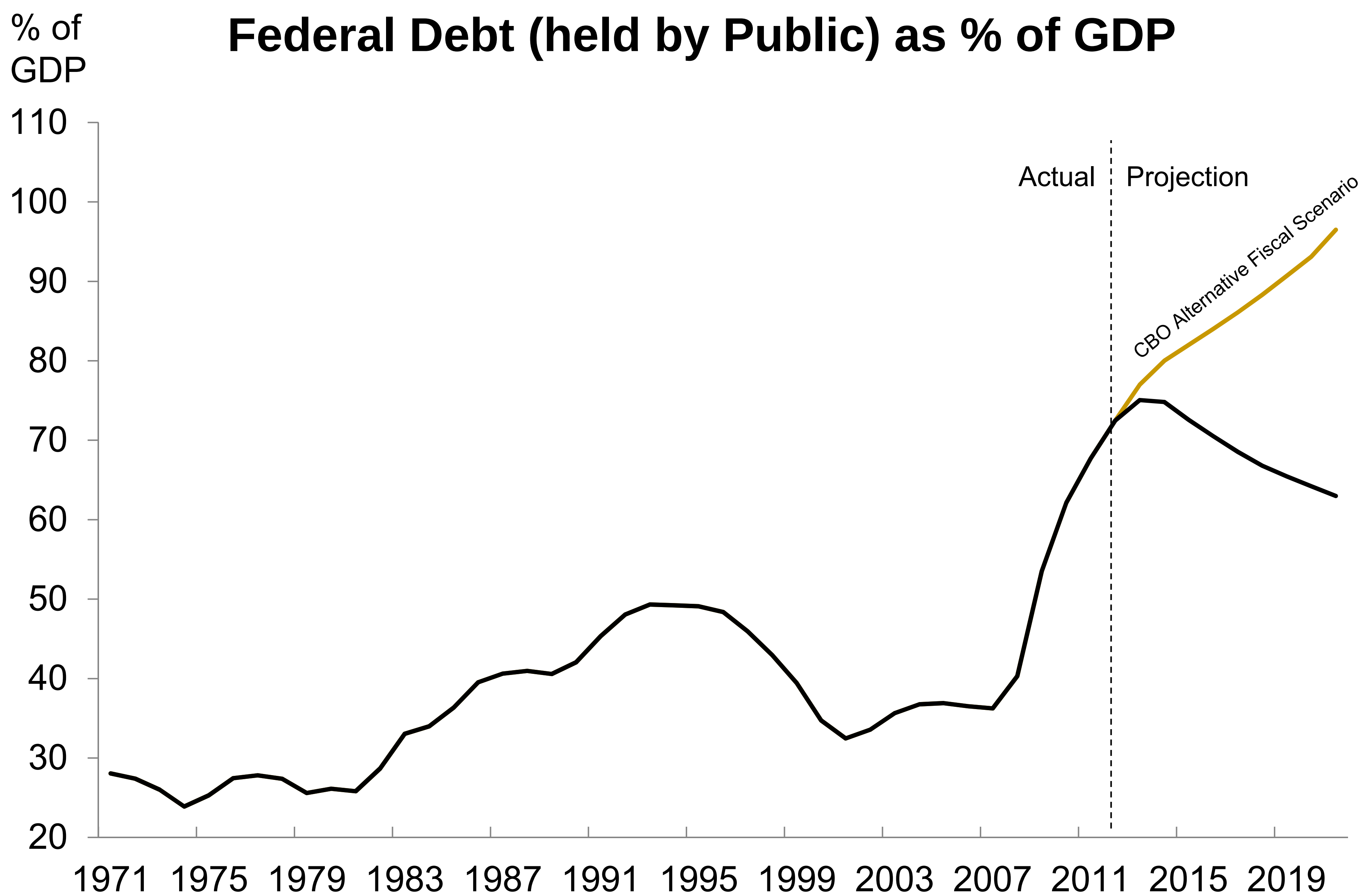

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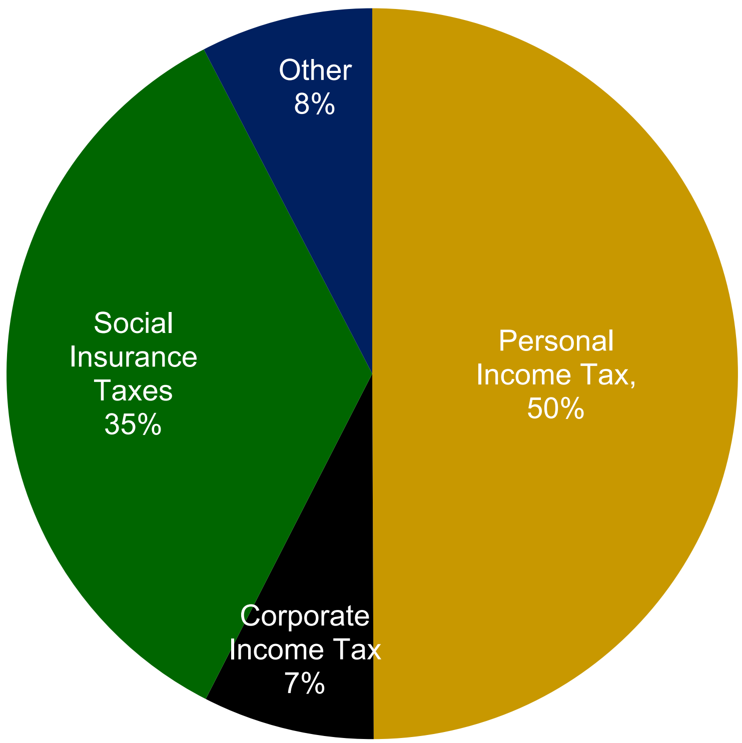
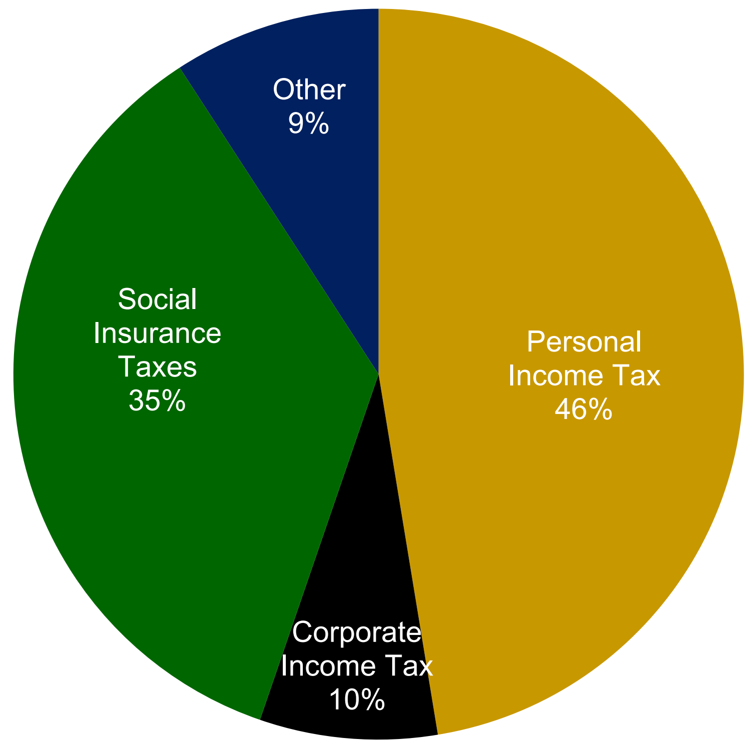
Federal Government Revenue

2001



$1,991 Billion
19.5% of GDP

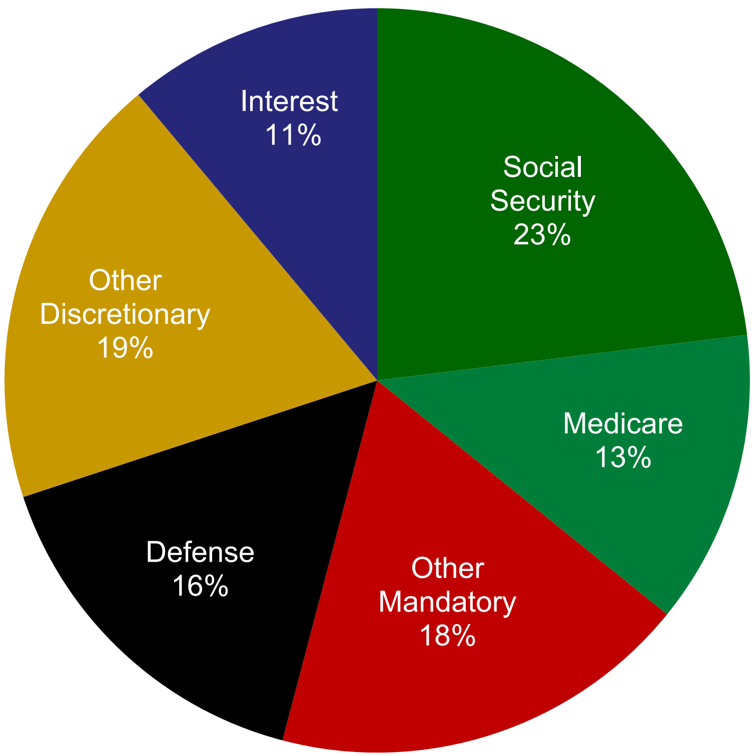
2012



$2,523 Billion
16.3% of GDP

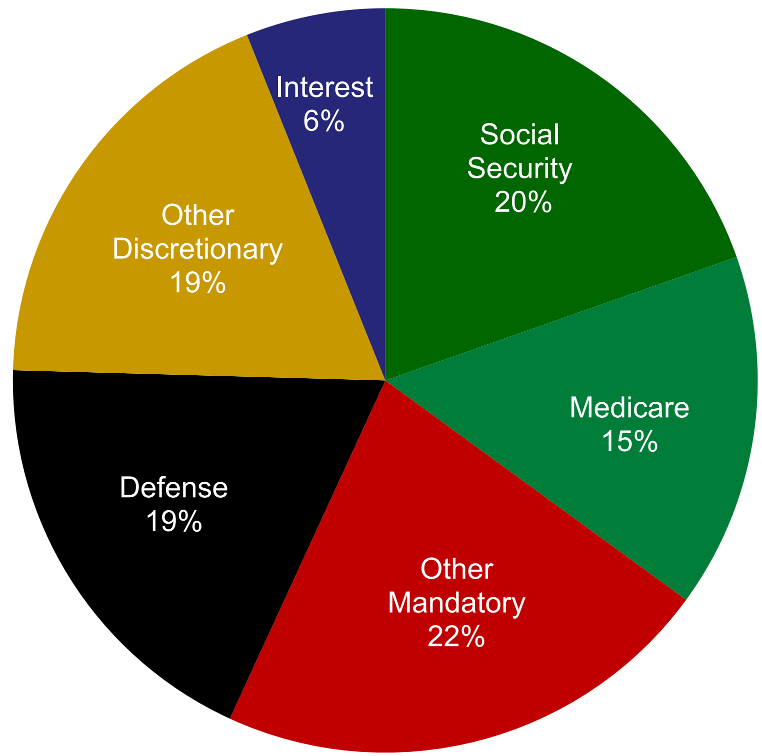
Federal Government Spending

2001



$1,863 Billion
18.2% of GDP

2012



$3,601 Billion
23.2% of GDP

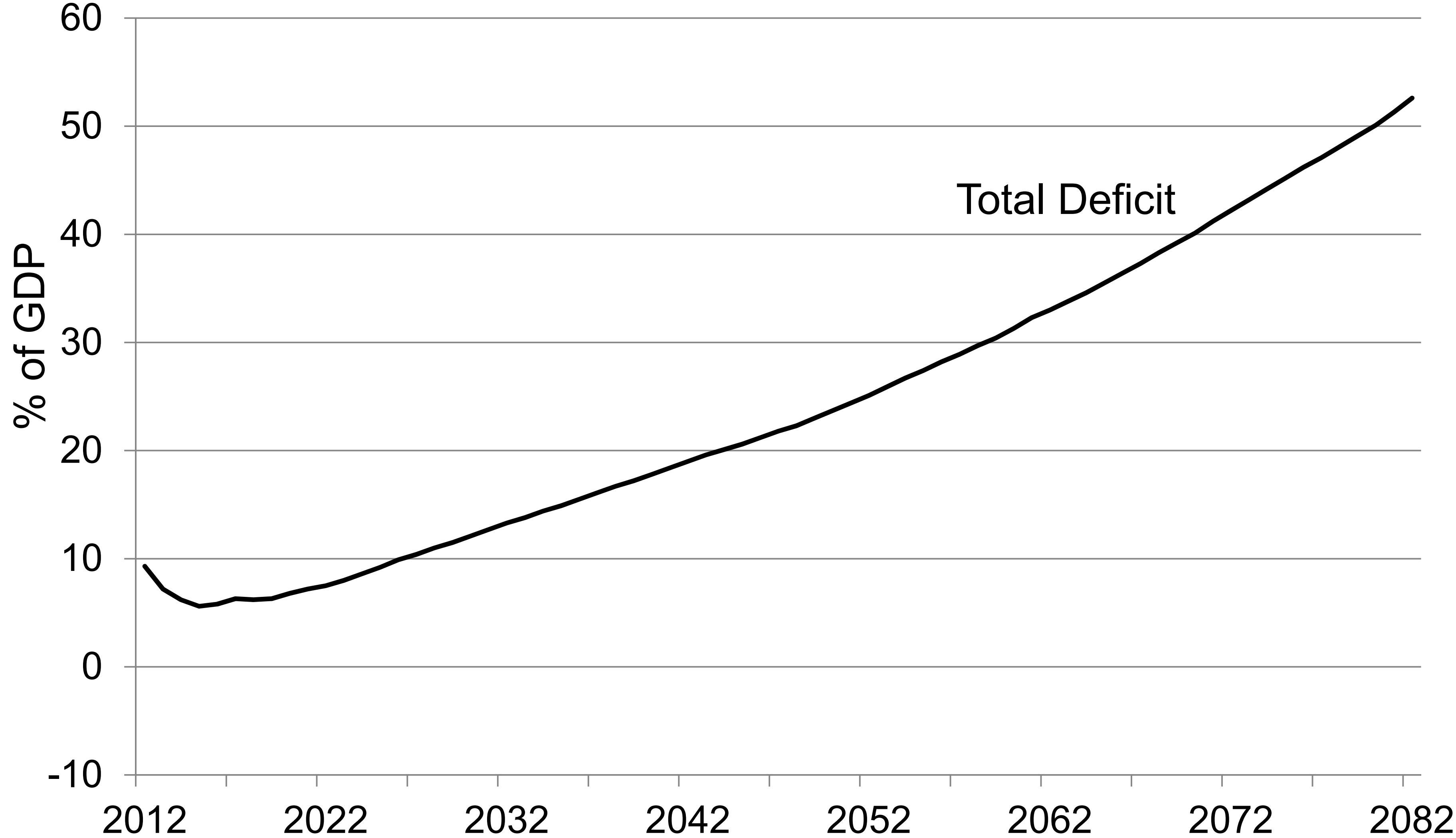
PURDUE UNIVERSITY

What are the Proposals to Reduce the Federal Debt?

1**. Don't worry about it today**

- Do we have an urgent deficit problem today? No
  - Unemployment is the urgent problem!
  - The U.S. can borrow at a zero real interest rate
  - We should spend more on:
    - stimulus, investment, job training, research funding
- When does the deficit problem get urgent?
  - More than 10 years from now

Federal Deficit as Percentage of GDP
CBO Long-Term Projection



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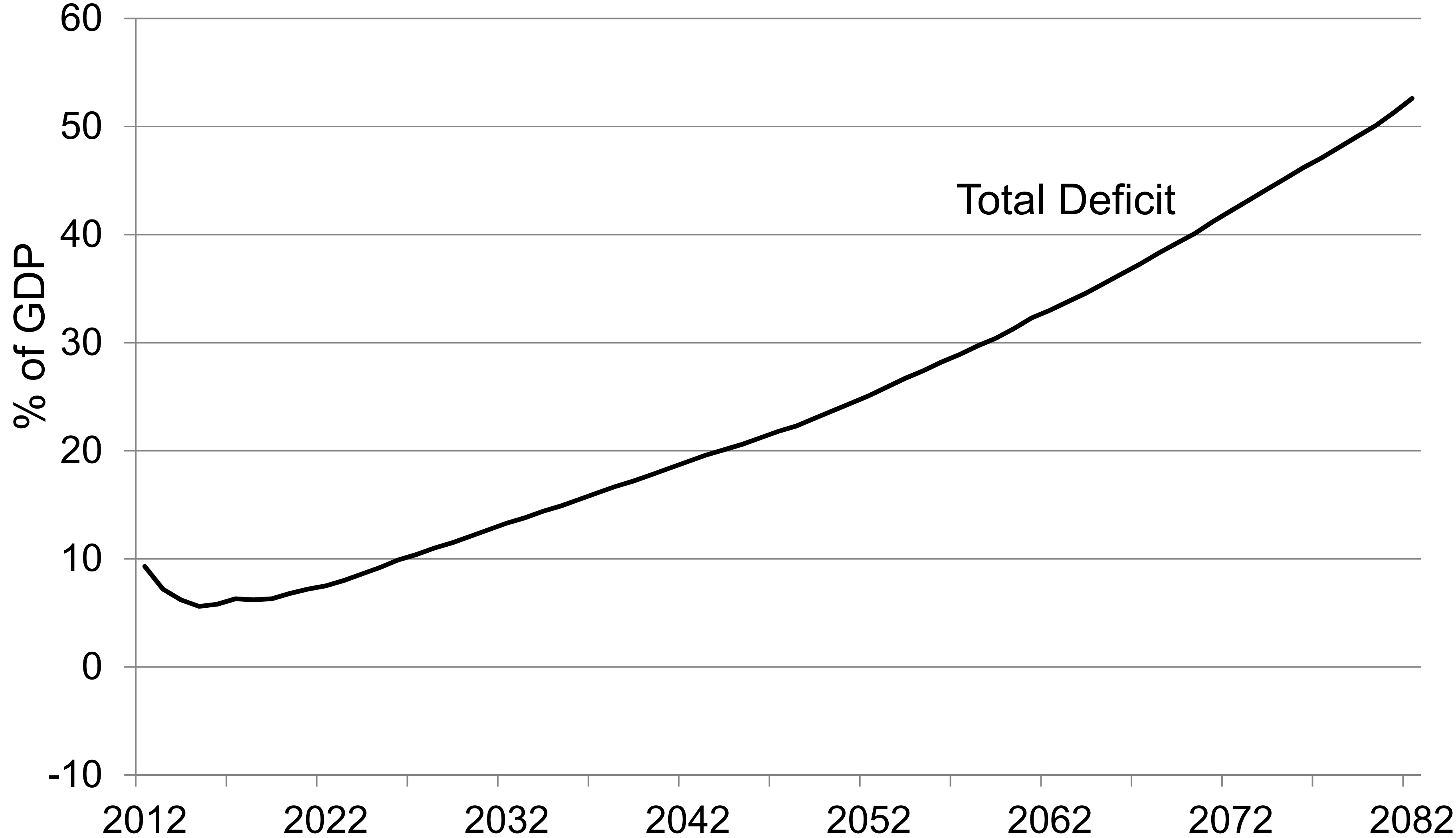
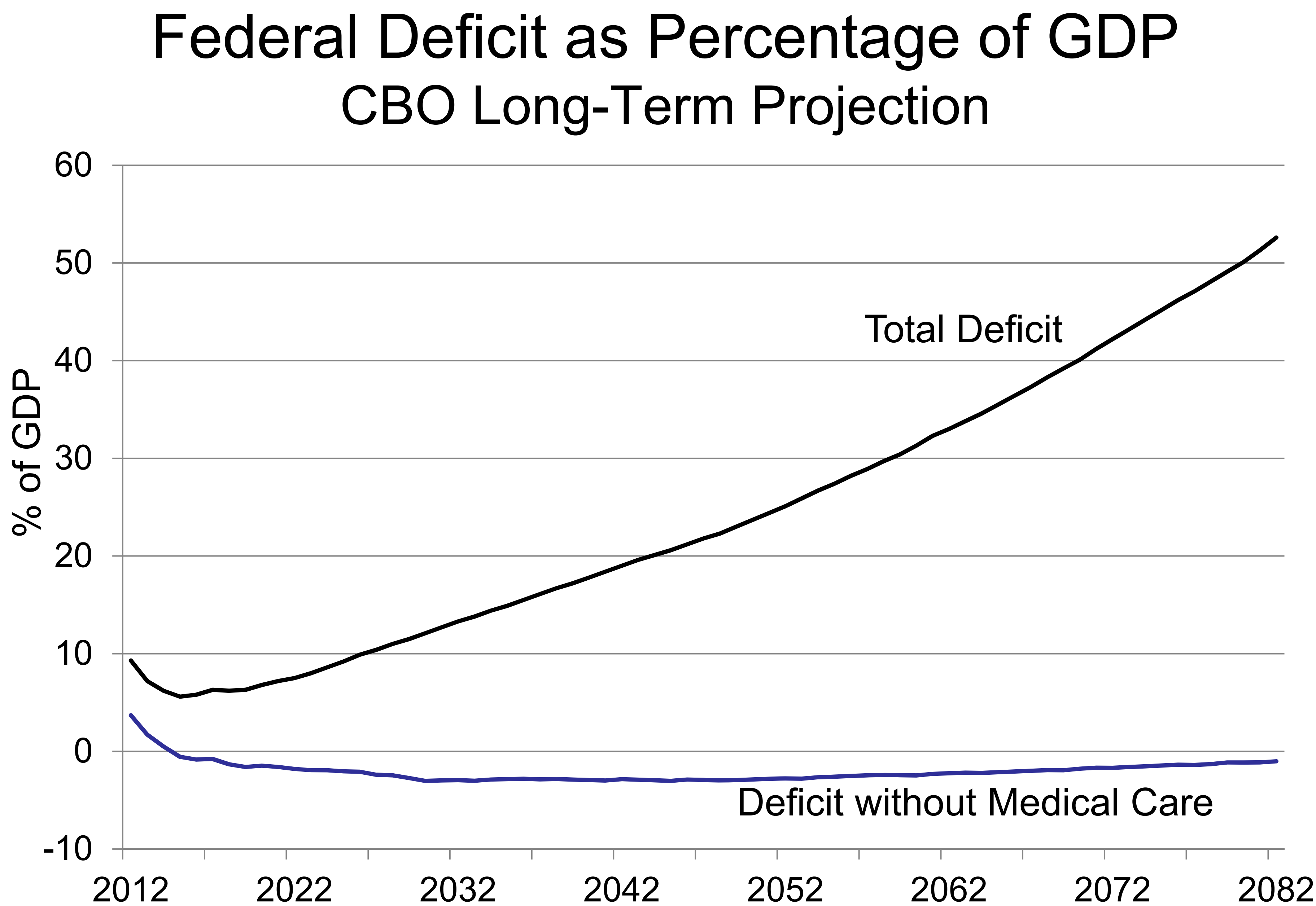
- When does the deficit problem get urgent?
  - More than 10 years from now
  - But it’s not about overspending
  - It’s medical care! (Medicare, Medicaid, etc.)

Federal Deficit as Percentage of GDP
CBO Long-Term Projection




Federal Deficit as Percentage of GDP
CBO Long-Term Projection
% of GDP
60
50
40
30
20
10
0
-10
2012
2022
2032
2042
2052
2062
2072
2082
Total Deficit
Deficit without Medical Care

What are the Proposals to Reduce the Federal Debt?

2**. Create a Federal Budget Constraint or Rule**

(The US doesn’t have a fiscal policy, just fiscal outcomes)

- The policy would require spending cuts
  - Health Care (reduce spending on Medicare & Medicaid)
  - Welfare Reduction (UI, Food Stamps, TANF, WIC)
  - Reduce Social Security Benefits (indexing, means-testing)
- And tax increases
  - Increase marginal rates (focus on high-income taxpayers)
  - Remove corporate loopholes
  - Broaden the tax base (eliminate popular deductions, flat tax)
  - National Sales Tax (VAT)

PURDUE UNIVERSITY

Are we Headed for a Crisis?

- We put most of the budget on automatic pilot:
  - In the 1960s we created Medicare and Medicaid
  - In the 1970s we indexed Social Security to wage growth
- Our constitution makes it difficult for the federal government to get anything done.
  - Congress has nearly complete control of the US budgeting process (president only has veto power)
- Sometimes there are major federal reforms:
  - 1983 Social Security Reform (trust fund crisis)
  - 1986 Tax Reform (no crisis)
- But I'm worried that it will take a debt crisis
  - Joint Select Committee (super committee) failure
  - "Compromise" has become a dirty word in politics

Contact Information:

Kevin J. Mumford
Department of Economics
Krannert School of Management

Email: mumford@purdue.edu
Web: www.krannert.purdue.edu/faculty/kjmumfor/

Teaching:

- Labor Economics (ECON 650) – PhD students
- Econometrics (ECON 560) – Master’s students
- Econometrics (ECON 360) – Undergraduates
- Public Finance (ECON 422) - Undergraduates