

## THE FED AND AN UNCERTAIN FISCAL FUTURE

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The United States faces a fiscal policy disaster. As is now becoming more widely appreciated, spending commitments under current laws and policy will outstrip the ability of conventional tax-based federal finance. More important, left unchanged these spending commitments are an economic threat that may undermine the future of U.S. macroeconomic performance. Because Federal Reserve policy is built on the outlook for the economy, the risks associated with the path of future fiscal policy, uncertainty over the pace, scale, and nature of fiscal reforms, and financial markets assessment of these risks will be a steady part of the Fed's policymaking diet.

### What Is the Fiscal Problem?

The fiscal problem has little to do with current budgetary outcomes. In fiscal year 2006, the federal budget deficit was 2 percent of GDP. In itself, this is hardly problematic, indeed it's business as usual in the postwar era—federal spending is typically 20 percent of GDP, revenues 18 percent, and the difference made up by federal borrowing. Thus, while a budget deficit of the current size could continue indefinitely, the problem is that it will not. Instead, current laws and policies will lead to tremendous budget pressures in the years to come.

To see this, consider the ratio of debt (in the hands of the public) to GDP, which is a bit below 40 percent. This ratio has two desirable characteristics as an indicator the long-run sustainability of current policies. First, the numerator reflects any cumulative mismatch between the outlays of the government and its tax receipts, which is the core concept of sustainability. Second, the denominator reflects the

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scale of the national economy that could, in principle, be devoted to the imbalance. Moreover, to the extent that there are pro-growth policies that might worsen the numerator but sufficiently augment economic growth, then the indicator will decline. This is exactly the type of sustainability barometer that one should examine.

Now, consider the political and policy mechanics of trying to sustain something close to current federal budget practice. At present, the federal government raises about 18 percent of GDP in receipts. That is, despite the tremendous attention paid to the tax bills passed in 2001 and 2003, revenues have recovered to their typical levels. In the other direction, the past two years have witnessed revenue “wind-falls”—receipts growth above that expected on the basis of economic growth—that cannot persist into the future. Thus, on balance the revenue system is configured to raise approximately 18 percent of GDP.

On the spending side, assume that Social Security reform remains unrealized and the benefits are paid as currently scheduled. That implies that outlays for Social Security will rise with the retirement of the baby-boom generation from about 4.5 percent of GDP now to 6.5 percent of GDP in 2030, and then continue to drift north to about 7 percent of GDP for the foreseeable future. In the process, Social Security will be transformed from a cash cow that provides excess funds to the remainder of the federal budget to a cash drain that will require annual infusions totaling over \$200 billion (in today’s dollars). The rise in Social Security spending is predictable—most of these future recipients are already in the labor force—and results from the permanent shift to an older population that will accompany the retirement of the baby-boom generation.

Given the rise in retirement spending, a bit of belt-tightening elsewhere will be needed. For illustrative purposes, adopt the current administration’s strategy of holding nondefense discretionary spending unchanged in nominal terms. But instead of holding it for five years, assume that the political will exists to hold it flat for nearly five decades. At the same time, suppose that defense discretionary spending is reduced immediately by about 25 percent and held constant for 50 years. This is a dramatic reversal of the cost of current policy in both the supplemental (Iraq, Afghanistan, etc.) and base defense budgets.

Is this fiscal policy sustainable? Not yet. Having succeeded in 50 years of annual political self-control, the only element missing to keep a stable debt-to-GDP ratio is a miracle. Specifically, the rate of “excess cost growth”—the difference between growth in spending per beneficiary and GDP per capita—in health programs must fall to

zero. For the past four decades, excess cost growth has averaged 2.5 percent. If this rate continues to prevail, Medicare and (the federal share of) Medicaid will rise from 4 percent of GDP to 22 percent of GDP in 2050, or larger than the entire current federal budget. Conventional assumptions (such as those of the Medicare trustees) are that excess cost growth cannot continue at historic rates and will moderate to 1 percent. However, even with this good news, Medicare and Medicaid will still triple in size to 12 percent of GDP and debt-to-GDP will still grow explosively.

This exercise makes clear that current fiscal policy is unsustainable, as even draconian restraint in the annual spending on defense and nondefense programs are insufficient to guarantee that the current level of taxation will be sufficient to cover promises to seniors in retirement and health programs. In short, U.S. fiscal policy requires fundamental shifts.

## When Does the Fiscal Problem Begin?

When will the excess spending commitments begin to manifest themselves? Since the core pieces of the fiscal policy problem—demographics and health care spending—are well known, in some sense the fiscal policy problem is (and has been) here. However, it is useful to contemplate the mileposts on the path to the future. Changes to Social Security, Medicare, and Medicaid are important political events, and politicians have highly developed senses of timing. For this reason, *when* the problem arrives is just as important as how large a problem politicians must face.<sup>1</sup>

An unfortunate feature of the current landscape is that too many believe that the “problem” arrives when budgetary trust funds are exhausted. In this view, Medicare becomes a problem in 2018 when the Health Insurance Trust Fund is depleted, and Social Security does not become an issue until its trust funds exhaust in 2040. This view misses the key point that Medicare—either in Part A, Part B, and Part D or as a whole—is currently running sustained year-by-year deficits that will grow over time. Similarly, Social Security will begin to run cash-flow deficits around 2017. Clearly, the problem arrives sooner than the end of the next decade.

<sup>1</sup>This is one drawback to efforts to place federal budgeting on a present value or accrual foundation. These approaches by definition collapse all future differences between spending and revenues into a single number in the present; that is, they eliminate all sense of timing. While this serves to make explicit the scale of the budgetary problem, it does not provide guidance as to which programs get out of control first.

Indeed, a good candidate for the public arrival of the U.S. fiscal problem is 2010. In 2010, the Social Security cash flow surplus is projected to reach its peak. Every year thereafter the excess of payroll taxes over retirement benefits will diminish and, along with it, the source of funds for future Congresses and administrations to meet spending demands in the military, domestic endeavors, and especially Medicare.

In addition, 2010 represents the year that the provision of tax law passed between 2001 and 2005 are scheduled to expire. Thus 2010 is a crucial point in the process of addressing our fiscal future: spending pressures will be evident and the political system will have a large, scheduled tax increase. What choices will be made?

The case can be made that the political arrival of the fiscal problem will occur during the 2008 presidential campaign. A provision of the 2003 Medicare Modernization Act (the “drug plan” bill) requires the Medicare Trustees to report if Medicare will require more than 45 percent of its funding to come from general revenue at any time over the next seven years. The Trustees reported this in March 2006, and undoubtedly will do so again in 2007. The law requires that after two consecutive reports the president must, in his next budget submission to Congress, provide proposals to bring Medicare back under the 45 percent threshold. This will occur in February 2008, just as the election campaign is heating up. It is difficult to imagine that this development will go unnoticed and candidates will likely be forced to develop positions regarding the best way forward.<sup>2</sup>

In sum, the fiscal problem is here in any deep economic sense, will arrive soon as a budgetary phenomenon, and may arrive even sooner in the political arena.

## Channels from Fiscal Policy to Monetary Policy

How will the fiscal policy outlook affect Federal Reserve actions? To begin, the future will *not* include the Fed monetizing enormous federal borrowing with concomitant (hyper)inflation. That is, I remain convinced that the United States can and will come to terms with fiscal reform, and that the Fed’s job will be to navigate the terrain imposed by that reform process.

The central economic impact of the rapid projected spending growth would be to further tilt the nation away from saving for the

<sup>2</sup>The law does *not* require Congress to pass any legislation. There are provisions for expedited consideration of the president’s proposals, but no requirement for action.

future. Retirement income and health programs are intended to ensure that beneficiaries can consume goods, services, and health care. The loss of savings, in turn, will slow the accumulation of funds needed to finance the foundations of sustained growth: the innovation and deployment of new technologies, the acquisition of education and skills, and the accumulation of new equipment, software, and structures.

Thus, the fiscal outlook is central to future productivity growth, both in the form of total factor productivity stemming from technologies and innovation and capital-deepening that leads to greater labor productivity. Of course, an anchor of Fed policy is to determine the projected path of the economy *relative* to its potential output. Thus, the future fiscal policy feeds directly into Fed decisionmaking through its impact on trend productivity growth and potential output growth. Uncertainty regarding this trend feeds directly into greater uncertainty on the appropriate stance for monetary policy.

This uncertainty has three related components: uncertainty regarding economic fundamentals, uncertainty regarding the path of future policy, and uncertainty regarding financial markets assessment of the fundamentals and policy. Let us consider each in turn.

Assessing the outlook for the fundamentals of productivity growth is likely the least difficult, at least in principle. The Fed's ongoing monitoring operations will detect shifts in the fundamentals of investment in new ideas and technologies, equipment, software, and physical structures. It will be able to detect shifts in the international pattern of investments, and thus any notable diversion of direct investments to other countries and concomitant impacts on international financial flows.

A more difficult problem may be assessing the future path of policy (and, thus, any subsequent economic impacts). At one end of the spectrum, one could imagine a fiscal reform that focuses exclusively on reducing the future growth in spending. This would have beneficial economic impacts—it would be the surest path to higher national saving—and involve the least policy uncertainty. Shifts in benefit formulae for Social Security and Medicare would have relatively slow-moving and predictable impacts on both the budget and the economy.

At the other end of the spectrum would be a policy characterized by budgetary triggers or other types of automated budget responses. In particular, any fiscal strategy that consists of delaying reform will likely rely more heavily on tax increases to bring the budget into alignment because waiting permits spending to grow and tax increases are “quicker” than benefit reductions. If delay is combined with automated responses—higher taxes if the budget deficit is too large—

then the future of policy would introduce more extreme impacts. It would be more difficult to predict when such triggers would be brought into actions and the impact of such a policy strategy on economic fundamentals would be more problematic to assess.

In the vast area between lie a range of combinations of spending growth reductions and tax increases, and an uncertain timing of any policy shifts. The outlook for fiscal policy *reform* is itself an important uncertainty that will increasingly figure into the formulation of monetary policy.

At the same time, financial markets will be simultaneously undertaking a series of similar assessments and the Fed will face a continued challenge to ensure that financial market expectations of monetary policy are consistent with the Fed's outlook. As a case in point, many observers are puzzled as to why financial markets have been so quiescent to date in the face of the looming budgetary problems. One straightforward resolution is that the scale of federal borrowing is not significant in the global pool of capital, and that financial markets are expecting a fiscal reform that precludes the more extreme outcomes outlined above. Going forward, the markets will continually assess the budgetary and policy outlook, and its implications for the U.S. investment climate.

## Conclusion

U.S. federal fiscal policy must and will change. But how it changes—slow, smooth reforms of spending, sharp intermittent increases in taxes, or something in between—is far less clear. Unfortunately, the approach taken has important impacts on the prospect for potential growth in the United States, and so uncertainty in fiscal policy introduces additional risks in monetary policy. This policy risk could possibly become a pervasive and increasingly important aspect of the monetary policy terrain.