THE EVOLUTION OF THE FEDERAL BUDGET AND FISCAL RULES

Richard W. Peach[*]

1. Introduction

Following roughly two decades of large federal deficits and rising federal debt as a share of GDP, the U.S. has enjoyed a dramatic improvement in its fiscal balance over the past several years. From a deficit of $290 billion or 4.7% of GDP in Fiscal 1992, the federal balance moved into surplus in FY1998 and that surplus rose to $237 billion or 2.4 percent of GDP in Fiscal 2000[1]. More recently, the improvement from deficits to significant surpluses has led to both faster growth of spending and a significant tax cut. Nonetheless, under current tax and spending policies and reasonable economic assumptions, the federal budget is projected to remain in surplus over the next decade. Of course, it is widely recognized that under current policies, by around 2015 the federal balance is likely to revert back to deficit as the baby-boom generation begins to retire and draw on federal retirement and health benefits.

Beginning in the mid 1980s, the federal government enacted a series of fiscal rules intended to reduce the deficits and put federal fiscal policy on a sustainable path. The first generation of fiscal rules established specific numerical targets for the deficit that proved to be politically impossible to meet as economic growth slowed in 1989 and 1990. Latter attempts were a blend of numerical targets on some categories of spending and budget process rules that were largely adhered to through most of the 1990s.

The fact that these rules were in place over the period when the federal balance moved from deficit to surplus naturally leads some to conclude it was

[*] Federal Reserve Bank of New York.
I would like to thank Donald Rissmiller and A.J. Glusman for their diligent research assistance. All errors and omissions are my own responsibility. The opinions expressed in this paper do not necessarily reflect the views of the Federal Reserve Bank of New York nor the Federal Reserve System.

[1] In the U.S., the federal fiscal year runs from October through September.

the rules per se that led to the improvement in the fiscal balance. This paper will argue that the rules certainly played a useful role. First, the rules were reasonably transparent; much more so than the traditional budget process. The rules significantly changed the debate on budget issues, keeping attention focused on the big picture of eliminating the deficits and so on the need to make tradeoffs. Gradually, as the rules were adhered to for a longer and longer period, the government's credibility was enhanced in financial markets, helping to reduce interest rates and the deficit.

But while helpful, rules are just rules. Ultimately it was the political will to first enact and then adhere to the rules that is the main explanation for the improvement in the federal balance. This political will stems from the fact that, after a recognition delay, voters had come to recognize that the stance of fiscal policy from the early 1980s to the early 1990s was unsustainable. What drove that home most powerfully was the rising federal debt and the periodic need to raise the statutory ceiling on that debt, a law that dates back to 1917. Indeed, the need to raise the debt ceiling was such an unambiguous symbol of failure on the part of the government that it often provided the catalyst for enactment of meaningful legislation to slow the growth of outlays and/or raise the growth rate of revenues.

That the fiscal rules of the 1980s and 1990s were "political symbolism" of sorts is made all the clearer by the fact that while those rules are still the law of the land they have been routinely ignored in recent years. The movement to surpluses has once again changed the fiscal debate from whether the deficit should be reduced by raising taxes or cutting spending to how much of the surplus should be returned to taxpayers in the form of tax cuts, how much should be used for additional spending, and how much should be used to pay down the existing stock of federal debt.

The outline of this paper is as follows. Section 2 provides a broad overview of trends in federal revenues, outlays, and debt over the post World War II period. Section 3 provides a chronology and brief description of the fiscal rules that have been enacted. Section 4 concludes.

2. Evolution of the Federal Budget

Over the 1950s and 1960s, despite the cold war with the former Soviet Union and armed conflict in Korea and Southeast Asia, the federal government ran relatively modest deficits. Over those two decades, the federal balance was in deficit by an average of $3.7 billion (0.6 percent of GDP) per year. While in nominal terms the stock of federal debt continued to grow, it fell steadily expressed as a percent of GDP (figure 1).

However, conditions began to change by the mid 1970s as the growth of outlays increased due primarily to the expansion of federal entitlement programs or transfers (figure 2). The Social Security program was made more generous in terms of benefits and coverage over the 1950s, 1960s, and early 1970s. Medicare Part A and Part B as well as Medicaid were enacted in 1965. In contrast, defense spending was declining rapidly as a share of GDP.

Over the second half of the 1970s revenues also rose as a share of GDP, limiting the size of the deficits such that debt held by the public remained fairly stable as a share of GDP. The rapid growth of revenues was due in large part to the rapid inflation of that period, which led to rapid growth of nominal incomes which in turn pushed individuals into higher marginal tax rate brackets (their were considerably more brackets and higher marginal rates at that time). The enactment of the Economic Recovery Tax Act of 1981 significantly reduced the level of receipts as a share of GDP while also limiting their future growth rate by lowering individual income tax rates and by introducing inflation indexing into the individual income tax code. Even though outlay growth began to slow in the 1980s, despite a relatively moderate rise in defense spending, the size of the gap between outlays and revenues was quite large. It narrowed a bit in the late 1980s in response to robust economic growth, but then widened again in the early 1990s as the economy experienced a relatively mild and brief recession followed by several years of sluggish economic growth. Over the period from 1983 to 1992 the deficit averaged 4.3 percent of GDP. These large and sustained deficits caused the stock of debt held by the public to rise from around 25 percent of GDP in the mid 1970s to around 50 percent of GDP in the early to mid 1990s. Expressed as a share of total household sector financial assets, the stock of federal debt held by the public also roughly doubled, from around 10 percent in the mid 1970s to around 20 percent by the early 1990s (figure 3).

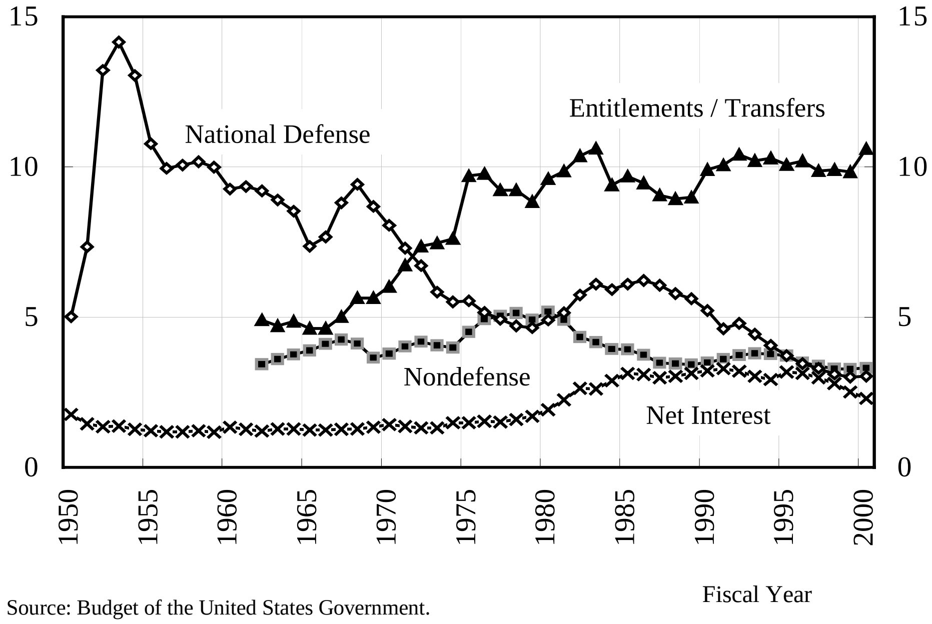
Figure 1

Federal Receipts and Outlays and Debt Held by the Public
(percent of GDP)

Source: Department of the Treasury.

Figure 2

Federal Outlays by type
(percent of GDP)

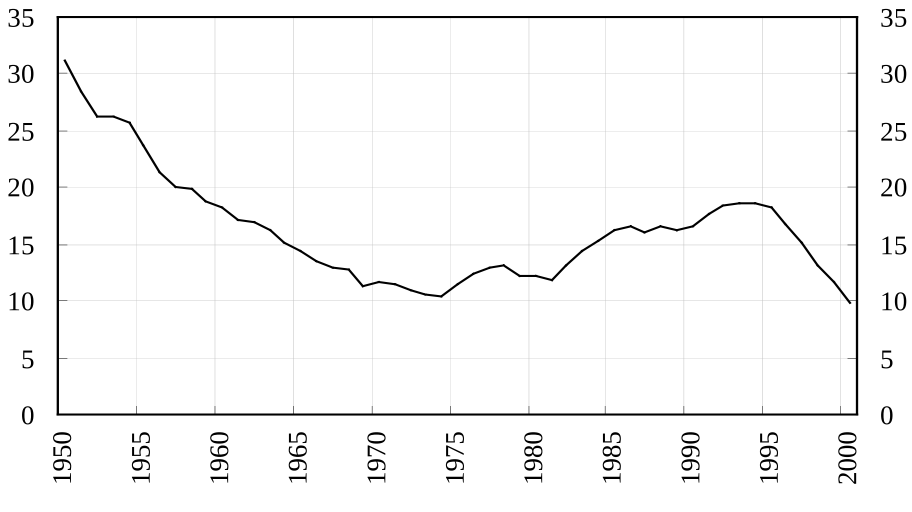


Source: Budget of the United States Government.

Since 1992, the U.S. has experienced a dramatic improvement in its federal fiscal situation. From a deficit of $290 billion or 4.7% of GDP in Fiscal 1992, the federal budget moved into surplus in Fiscal 1998 and that surplus rose to $237 billion or 2.4 percent of GDP in Fiscal 2000. The transition from deficits to significant surpluses led to faster growth of spending in FY2000 and FY2001 and a significant tax cut enacted in mid 2001. Nonetheless, under current tax and spending policies and reasonable economic assumptions, the federal budget is projected to remain in surplus over the next decade (cfr. figure 4 and table 1). However, it is widely recognized that, due to the aging of the population, the current policy fiscal projections over the next 50 years are quite gloomy.

Figure 3

Federal Debt Held by the Public
(percent of Household Financial Assets)

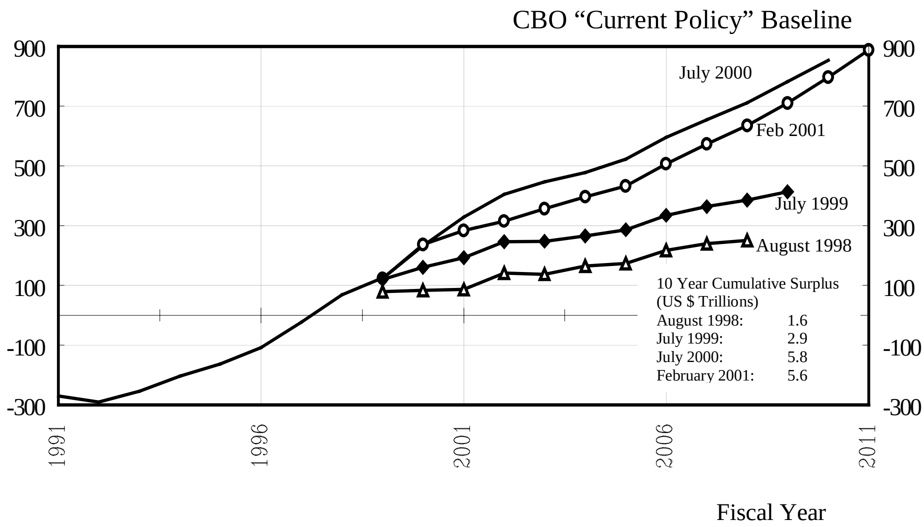


Source: Council of Economic Advisors, Department of the Treasury, and Board of Governors of the Federal Reserve System.

The source of the 7 percent of GDP swing in the federal fiscal balance over the period from Fiscal 1992 to Fiscal 2000 was a 3.3 percentage point of GDP rise of total revenues and a 3.8 percentage point decline of total outlays. Most of the improvement in receipts was in individual income taxes (up 2.7 percentage points), while corporate income tax receipts also rose as a share of GDP (up 0.5 percentage points) due to a rise of corporate profits as a share of national income (cfr. table 2). The sharp rise of individual income taxes as a share of GDP has been the largest surprise and the largest source of error in the underestimation of federal receipts in recent years. There are three main reasons for this surprising growth: (1) growth of taxable personal income in excess of growth of GDP, (2) growth of adjusted gross income in excess of growth of taxable personal income, and (3) increases in effective tax rates on adjusted gross income (CBO, 2000).

Figure 4

Federal Unified Balance
(billions of US Dollars)



Over the period from Fiscal 1994 to Fiscal 2000, taxable personal income, which consists of wages and salaries, personal interest income, personal dividend income, rental income of persons, and proprietors' income, rose from 68.2 percent of GDP to 71.3 percent of GDP. Similarly, corporate profits before tax rose from under 7 percent of GDP in Fiscal 1991 to 9.5 percent of GDP in Fiscal 1997. A major reason that all of these income shares rose is that the statistical discrepancy between the income side and product side of the U.S. National Income and Product Accounts (NIPAs) widened substantially over the past several years. The statistical discrepancy, an entry on the income side of the ledger that forces GDP as measured by total income to equal GDP as measured by total expenditures, went from +0.3 percent of GDP in 1991 to –1.3 percent of GDP in 2000. As a result, national income rose at a compound annual rate of 5.9% over that nine-year period while GDP rose at a 5.7% compound annual rate.

Table 1

Comparison of CBO Current-Policy Macroeconomic Assumptions (Fiscal Years)

		ACTUAL	FORECAST PROJECTIONS				AVERAGE
	Date	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004-2009/20
Real GDP	8/98	2,3	1,9	1,7	2,2	2,5	2,3
	7/99	4,1	2,8	2,3	2,3	2,3	2,5
	7/2000	4,1	5,1	3,4	2,8	2,8	2,7
	2/2001	4,2	4,6	2,7	3,2	3,4	3,0
CPI-U	8/98	2,4	2,8	2,7	2,5	2,5	2,5
	7/99	1,9	2,5	2,5	2,5	2,5	2,5
	7/2000	1,9	3,0	2,7	2,7	2,7	2,5
	2/2001	1,9	3,2	2,9	2,8	2,8	2,5
3-month T-Bill	8/98	5,3	4,9	4,6	4,5	4,4	4,4
	7/99	4,5	5,0	4,8	4,5	4,5	4,5
	7/2000	4,4	5,6	6,6	5,6	5,1	4,8
	2/2001	4,6	5,7	5,2	4,8	5,1	4,9

Table 2

Federal Receipts by Type

	Percent of Total	Percent of GDP		
		FY 1992	FY 2000	Change
Total	100.0%	17.5%	20.8%	3.3
Individual Income	49.6%	7.7%	10.4%	2.7
Individual Withheld	34.0%	5.6%	7.1%	1.5
Individual Nonwithheld	15.6%	2.0%	3.3%	1.3
Capital Gains	5.8%	0.4%	1.2%	0.8
Social Insurance	32.2%	6.6%	6.7%	0.1
Corporate	10.2%	1.6%	2.1%	0.5
Other*	8.0%	1.6%	1.7%	0.1

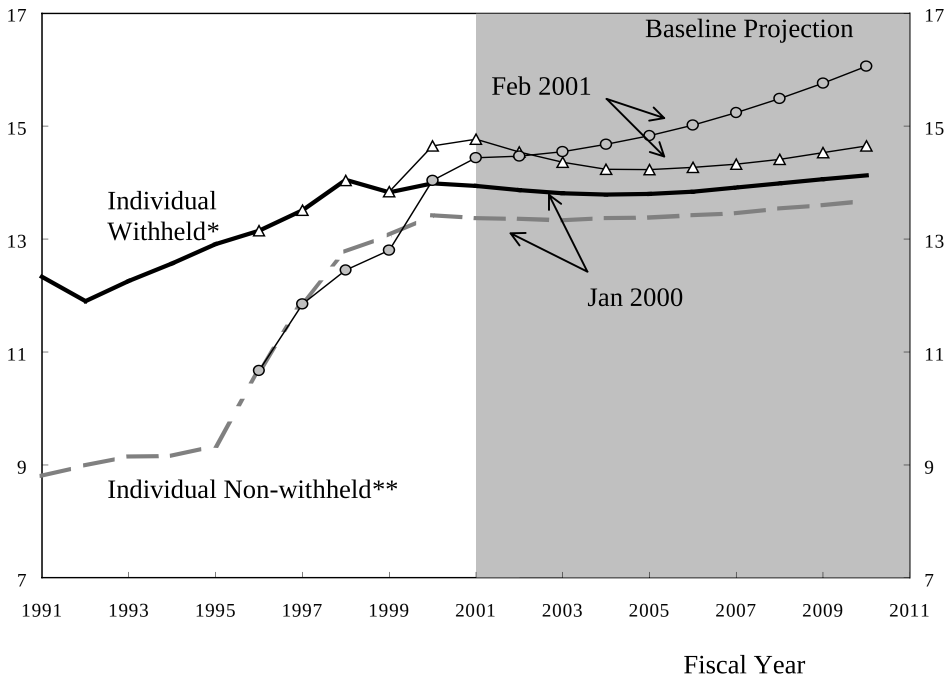
* Includes excise taxes (3.4%), estate and gift taxes (1.4%), customs duties (1.0%) and miscellaneous (2.1%).
Note: Individual components may not sum to totals due to rounding.

Adjusted gross income (AGI), the income concept used as the basis for income taxation, rose faster than taxable personal income due to sharply increased capital gains realizations, larger withdrawals from tax-deferred accounts such as IRAs and 401ks, and the fact that an increasing share of Social Security benefits became subject to taxation. The final, and most important, reason for the rapid rise of individual income taxes over this period is the rise of average effective individual income tax rates (see figure 5). This is due to increases in real income, which push taxpayers into higher marginal rate brackets (real bracket creep), and shifts in the distribution of income toward higher-income taxpayers, as shown in table 3.

Figure 5

Trends in Effective Tax Rates

(percent)



* Percent of wage and salary income.

** Percent of proprietors' income, rental income of persons, personal divided income, and personal interest income.

Table 3

Percentage of Returns, Adjusted Gross Income and Tax Liabilities for High-Income Taxpayers, Tax Years 1993-1998

AGI (1998 dollars)	1993	1998*
Percentage of Returns		
200,000 and above	1,1	1,6
500,000 and above	0,2	0,4
1 million and above	0,1	0,1
Percentage of AGI		
200,000 and above	14,5	21,6
500,000 and above	7,7	13,1
1 million and above	4,9	9,3
Percentage of Tax Liabilities		
200,000 and above	29,8	39,8
500,000 and above	17,5	25,6
1 million and above	11,4	18,3

Source: Congressional Budget Office.
Note: AGI = Adjusted Gross Income.
* Data are based on tax returns processed through November, 1999.

Turning to outlays, Table 4 presents the major categories of outlays expressed as a percent of GDP for Fiscal 1992 and Fiscal 2000. In total, outlays fell from 22.2 % of GDP in Fiscal 1992 to 18.4% in Fiscal 2000, a decline of 3.8 percentage points to the lowest level since the mid 1960s. About half of the total decline was in defense outlays, which fell 1.9 percentage points of GDP over the period. Entitlement outlays also fell as a percent of GDP, due to relatively slow growth of new retirees over the period, concerted efforts to slow the growth of health care outlays in both the public and private sectors, and the combination of strong economic growth and policy changes which slowed the growth of means-tested entitlement programs. Finally, with both lower interest rates and a declining stock of debt, net interest payments also fell as a share of GDP.

Table 4

Budget Enforcement Act Presentation of Federal Outlays

	% of Total	% of GDP		
		FY1992	FY2000	Change
Outlays	100,0%	22,2%	18,4%	-3,8
Discretionary	34,5%	8,6%	6,3%	-2,3
Defense	16,5%	4,9%	3,0%	-1,9
Nondefense	18,0%	3,7%	3,3%	-0,4
Entitlements/ Transfers	57,5%	11,5%	10,6%	-0,9
Social Security	22,7%	4,6%	4,2%	-0,4
Medicare	12,1%	2,1%	2,2%	0,1
Medicaid	6,6%	1,1%	1,2%	0,1
Other *	16,1%	3,8%	3,0%	-0,8
Net Interest	12,5%	3,2%	2,3%	-0,9
Other	-4,5%	-1,1%	-0,9%	0,2

* Family Support (AFDC), SSI, EITC, Student Loans, Farm Price Supports, Federal Civilian and Military Retirement, etc.
Note: Individual components may not sum to totals due to rounding.

3. Overview of Fiscal Rules

Federal law contains numerous provisions that can be labeled fiscal rules. Some of these provisions are quite old, such as the debt ceiling, while most were enacted in an attempt to reduce the large deficits of the 1980s and the first half of the 1990s. This section provides an overview of the main fiscal rules. Note that this review does not attempt to explain all of the legislative detail of these laws, which is often quite complex.

A. *Statutory Debt Ceiling*

The Liberty Bond Act of 1917 established a statutory limit on the gross indebtedness of the federal government. This was introduced as a simplifying procedure during World War I, as prior to the passage of this law each individual bond issue had to be approved by Congress. In the 1980s and 1990s the need to raise the federal debt ceiling often provided the catalyst for enactment of deficit reduction legislation.

B. *Congressional Budget and Impoundment Control Act of 1974*

The Budget Act, as it is called, established the current congressional budget process and in so doing introduced some discipline to that process. The Act established the House and Senate Budget Committees, the adoption of a Congressional Budget Resolution, and the reconciliation process. It also created the Congressional Budget Office, which gave the Congress an analytical capability comparable to that of the Executive Branch.

C. *Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings I)*

This act established declining deficit targets for each year through Fiscal 1991, at which point the budget was to be balanced. It also established a sequestration process under which previously approved spending was canceled if the projected deficit exceeded the target. However, the actual deficit did not need to meet the target, even if Congress changed policy over the course of the year. The sequestration process was to be controlled by the General Accounting Office, a branch of Congress.

D. *Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Gramm-Rudman-Hollings II)*

The Supreme Court had ruled that having the sequestration trigger in the hands of the General Accounting Office was a violation of the Constitutional principle of separation of powers. Under this legislation, the sequestration trigger was placed in the hands of the Director of the Office of Management and Budget (OMB), an office of the Executive Branch. In addition, the deficit targets were revised and extended to FY1993, at which time the budget was to be balanced.

E. Budget Enforcement Act of 1990

As part of a major deficit reduction package that included increases in taxes and reductions in spending, the Budget Enforcement Act (BEA) significantly altered the budget enforcement mechanisms. First, it effectively eliminated deficit targets. In their place it established nominal ceilings or "caps" on discretionary budget authority and outlays over the period from Fiscal 1991 to Fiscal 1995. Discretionary outlays, which currently represent about one-third of total outlays, are those which are controlled by the annual appropriations process. The caps are adjustable to accommodate "emergencies" as well as other extenuating circumstances such as funding for the International Monetary Fund. When initially enacted in 1990, there were three separate caps for defense, international, and nondefense domestic spending for the period from Fiscal 1991 through Fiscal 1993. Then from Fiscal 1994 to Fiscal 1995 there was a single cap covering the total discretionary category.

In addition, the BEA established the "pay-as-you-go" or "PAYGO" process for revenues and direct spending. Direct spending is for the most part entitlements or transfer programs that are established through authorizing legislation. Outlays are determined not by annual appropriations but rather by the eligibility criteria and benefit formulas of the specific programs in combination with underlying economic and demographic conditions. Under PAYGO, all changes in the tax code and in direct spending enacted in a session of Congress must be "deficit neutral" over one year and five year horizons. The Senate subsequently enacted a 10-year horizon test as well[2]. PAYGO does not require congressional action if revenues fall or outlays grow

2 The PAYGO provision made the scoring or pricing of legislation a critical exercise and introduced a new form of lobbying. Interest groups would higher consultants to influence the way in which their favored provisions were scored so as to minimize their cost.

due to changing economic or technical assumptions such as demographic conditions and endogenous changes in effective tax rates. PAYGO is enforced one year at a time, meaning that an overage in one year can not be offset by an underage in another year. Moreover, an underage or overage in the PAYGO section of the budget can not be transferred to the discretionary section of the budget and vice versa.

Both the discretionary spending caps and PAYGO are enforced through the threat of sequestration, an executive order permanently canceling some previously approved spending. As mentioned above, the 1985 act (Gramm-Rudman-Hollings I) established the sequestration process. The BEA of 1990 established new, more elaborate sequestration rules and procedures.

F. Federal Credit Reform Act of 1990

This Act changed the budget treatment of direct loans and loan guarantees by the federal government. Prior to this legislation, direct loans were treated as outlays when funds were dispersed. The outlays were netted against repayments of principal and interest. Loan guarantees were recorded as outlays only when there was a default that prompted the federal government to make good on its guarantee. Under the Credit Reform Act, the estimated discounted present value of the subsidy inherent in a direct loan or guarantee is scored as an outlay in the year in which the loan or guarantee is made.

G. Omnibus Budget Reconciliation Act of 1993

In addition to raising tax rates on upper-income taxpayers and reducing spending, the Act extended the discretionary spending caps and PAYGO through FY1998.

H. Line Item Veto Act of 1996

This law granted the President authority to cancel selected categories of spending and tax provisions over the period from FY1997 to FY2004. It was ultimately struck down by the Supreme Court.

I. Budget Enforcement Act of 1997

This legislation extended the discretionary spending caps and PAYGO through Fiscal 2002. Separate caps were again imposed on defense and nondefense discretionary spending for the period from Fiscal 1997 to Fiscal 1999. In addition, a separate cap was introduced for a new category of outlays called Violent Crime Reduction for the years Fiscal 1997 to Fiscal 2000. After that, all discretionary spending was again covered under a single cap. As part of the Transportation Equity Act for the 21st Century, a separate cap for highway and mass transit spending was enacted. In reality, these special caps were not ceilings but floors on categories of spending with particularly strong constituencies.

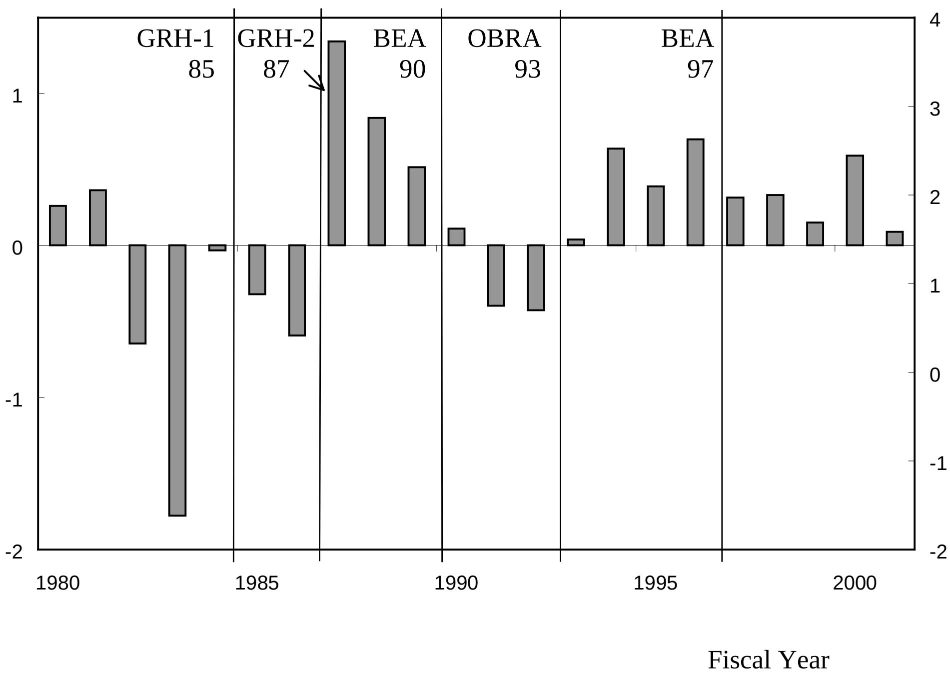
4. Fiscal Rules and Changes in the Primary Structural Deficit

While the fiscal rules of the 1980s and 1990s became more elaborate, they were easily circumvented or simply overridden when political pressure to restrain spending eased. For example, in the development of the budgets for Fiscal 1999 and Fiscal 2000, the discretionary spending caps were effectively overridden by declaring large increases in outlays to be “emergency” spending. For Fiscal 2001, the Congress and the President simply enacted a very large increase in the discretionary spending caps to accommodate the level of spending they desired. Similarly, the tax cut enacted in 2001 should prompt a sequester under the PAYGO rules, but it is widely expected that those rules will be ignored.

One objective way of evaluating the effect of the enactment of fiscal rules on the stance of fiscal policy is to look at the change in the primary structural balance in the years immediately after enactment. The structural deficit or balance is what the federal balance would be if the economy was operating at potential. Accordingly, this measure of the balance is not affected by short-run variations in growth of GDP. The primary structural balance is the structural balance excluding interest payments on the stock of outstanding debt. By excluding the interest cost of debt accumulated in the past we are able to focus on the policy decisions of the present government. Changes in the primary structural balance indicate whether fiscal policy is tightening or easing.

Figure 6

Change in Primary Structural Balance
(as a percent of Potential GDP)



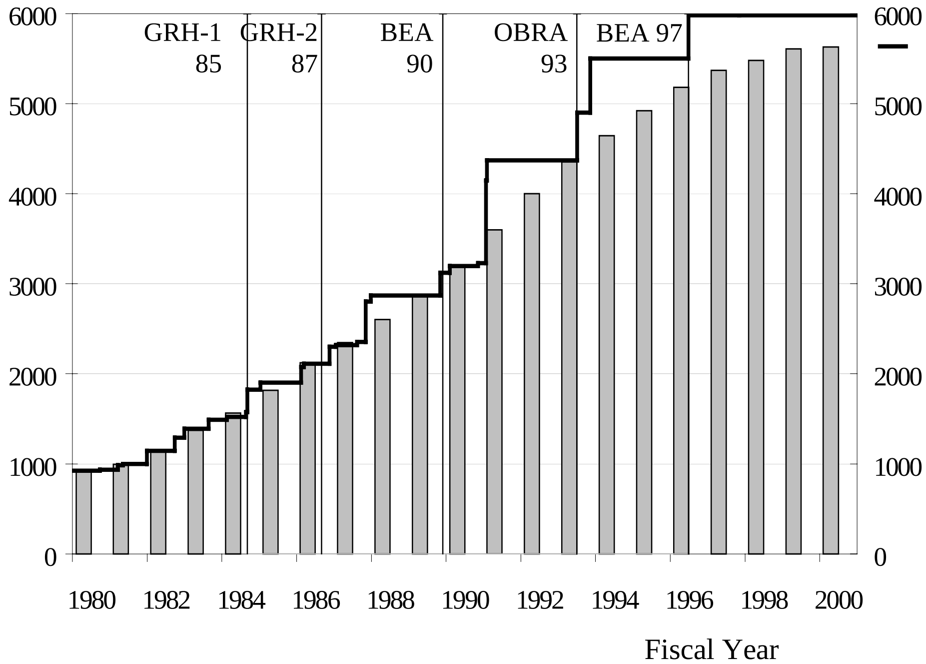
Source: Congressional Budget Office.

Figure 6 presents changes in the primary structural balance as a percent of potential GDP, both estimated by the Congressional Budget Office, for fiscal years from 1980 to 2000. Included in the chart are the dates of passage or extension of the major fiscal rules of the past two decades. One of the first things to note is that enactment of fiscal rules was not always associated with a shift toward contractionary fiscal policy. For example, enactment of the Budget Enforcement Act of 1990 was followed by expansionary fiscal policy until enactment of the deficit reduction package of the Omnibus Budget Reconciliation Act of 1993. The main reasons are two fold. First, while

BEA90 introduced the discretionary spending caps for the period from Fiscal 1990 to Fiscal 1995, the cap for Fiscal 1991 permitted a 6.6% increase in discretionary spending for that year, well above the 3.8% compound annual rate of growth over the preceding five years when Gramm-Rudman-Hollings I and II were in effect. Second, the late 1980s and early 1990s witnessed an explosion in the rate of growth of the federal health care programs (Medicare and Medicaid) due to expansion of eligibility and rapid increases in health care usage and prices. OBRA93 proved to be more successful in shifting the stance of fiscal policy to contractionary by reining in the growth of the these health care programs, in addition to some significant tax increases.

Figure 7

Federal Debt Ceilings and Gross Federal Debt
(billions of US Dollars)



Source: Council of Economic Advisors.

Figure 7 presents the total amount of federal debt subject to limit and the statutory debt ceiling for the period from fiscal 1980 to fiscal 2000. Note that the dates of enactment of fiscal rules and deficit reduction packages always correspond to periods when it was necessary to raise the debt ceiling. Note also that over time, when the debt ceiling needed to be increased, it tended to be increased by larger amounts. This demonstrates the power of this relatively simple rule that quite by accident became instrumental in the improvement of the federal fiscal balance.

5. Conclusion

Fiscal rules can be effective in restraining fiscal policy as long as they are adhered to. They are more likely to be adhered to if compliance can be easily observed, such as whether the stock of debt is rising. But most important of all, a majority of voters must be convinced that adherence to the rules is in their interest.

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