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Back to the Future: Prospective Deficits through the Prism of the Past

by David Altig and Jagadeesh Gokhale

The Omnibus Budget Reconciliation Act of 1993 — the framework for the Clinton administration's current and future budget proposals — seems to be a success. However, the details of the Act are very similar to the long-term budget plan passed in 1990, legislation that failed to deliver the deficit reduction it promised. This article documents the fact that the failure of the 1990 law is, to a significant degree, attributable to "technical" problems that were largely unanticipated and that are not yet well understood. Thus, the prospects for declining deficits may be as much a matter of luck as of design.

Approaching the halfway mark of fiscal year (FY) 1994, the Clinton administration's first major piece of budget legislation — the Omnibus Budget Reconciliation Act of 1993 (OBRA93) — appears to be a smashing success. According to the Congressional Budget Office's (CBO) January estimate, this fiscal year's federal deficit will be some $64 billion less than forecasted before the legislation was passed.[1]

Furthermore, the President's FY1995 budget proposals hew closely to the OBRA93 blueprint, and if all goes as planned, the multiyear changes will be even more dramatic. In fact, the longer-run outlook has actually improved since last summer. In September, CBO calculations projected that the budget goals articulated in OBRA93 implied five-year deficits for FY1994–98 totaling about $506 billion less than was "forecast" before the legislation was enacted.[2] The CBO's latest published figures now foresee cumulative FY1994–98 totals that are $115 billion below the shortfall expected just a half-year ago.

This experience is in sharp contrast to the Bush administration's major budget law, the Omnibus Budget Reconciliation Act of 1990 (OBRA90). After just over one year as law of the land, the provisions of OBRA90 had proven insufficient to avoid an upward adjustment in the CBO's five-year FY1992–96 deficit forecast of nearly $540 billion. By January 1993, the initial estimates of $273 billion in deficits for FY1994–96 had been increased to $862 billion.

The radical differences in the periods immediately following OBRA90 and OBRA93 are all the more interesting because of the important similarities in the two pieces of legislation. Both bills set budget goals designed, over five-year horizons, to reduce deficit accumulations by about $500 billion from the paths expected in their absence. Both provided for lower outlay and higher revenue paths than did extant law, including increases in marginal tax rates for high-income taxpayers and a rise in fuel-related excise taxes. And both bills placed explicit multiyear caps on certain types of expenditures, as well as pay-as-you-go restrictions on all potential entitlement programs.

Thus, the same approach widely believed to have failed in stemming a deterioration of our fiscal situation during the previous administration is now being hailed as a significant step toward the promised land of permanently lower federal deficits. Before accepting this conclusion, we should pause to ask why OBRA90 did not live up to its promises. Is OBRA93, by virtue of its striking resemblance to OBRA90, destined to suffer the same fate? Or are deficit outcomes largely a matter of circumstances unrelated to either piece of legislation, suggesting that, when it comes to recent budget policy, it's better to be lucky than good?

These are the questions explored in this *Economic Commentary*. We begin by noting that, judged against actual deficit outcomes, OBRA90 delivered during

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its first three years almost exactly what was promised when signed into law by President Bush. But this measure of success was obviously misleading and satisfied no one. Temporary factors over the FY1991–93 period had helped to offset more fundamental problems with basic outlay and revenue trends, and the outlook for the future had deteriorated substantially.

Even more disturbing is that most of the problems encountered by OBRA90 were of a technical nature, meaning changes in revenue and spending that cannot be directly attributed to policy decisions or economic conditions. Under this terminology, technical factors are a measure of our ignorance — ignorance of extraordinary events that we cannot foretell, such as military conflict, and ignorance of why some policies do not deliver as expected, such as the failure of tax rate increases to raise revenues as projected.

These observations together provide yet another illustration of why deficits are a seriously deficient focal point for fiscal policy.[3] The downfall of OBRA90 was not its failure to meet immediate deficit targets, but its lack of reliable mechanisms for implementing desired revenue and expenditure plans in light of changing circumstances. As we emphasize below, nothing in OBRA93 has corrected this fundamental weakness.

■ In What Sense Did OBRA90 Fail?
By most accounts, OBRA90 was not a successful experiment. Acknowledging the arguable proposition that things would have been worse without it, and conceding that some — maybe most — of the discipline imposed on the FY1994 and FY1995 budget processes is a direct result of restrictions put in place by the 1990 legislation, OBRA90 is still widely seen as a major disappointment.

On one level, this view is somewhat surprising. In January 1991, just after OBRA90 was signed into law, the CBO projected that the new legislation would result in deficits totaling $797 billion over the first three years of the plan. The actual total for FY1991–93 turned out to be about $815 billion. Thus, OBRA90 delivered deficit outcomes that were, cumulatively, a mere 2 percent higher than promised, hardly the stuff of a complete breakdown.

TABLE 1 ACTUAL VS. PROJECTED BUDGET ITEMS, FY1991–93 (Billions of dollars)

	Projected	Actual	Contribution to Changes in Projected Deficits
The good news			
Deposit insurance outlays	249	40.9	–208.1
Net interest	624	592.8	–31.2
Offsetting receipts	193	241.9	–48.9
The bad news			
Discretionary outlays	1,583	1,605.2	31.2
Mandatory outlays	2,050	2,107.0	57.0
Revenue collection	3,515	3,298.0	217.0

NOTE: Projected totals are as of January 1991. Actual totals are as of January 1994.
SOURCE: Congressional Budget Office.

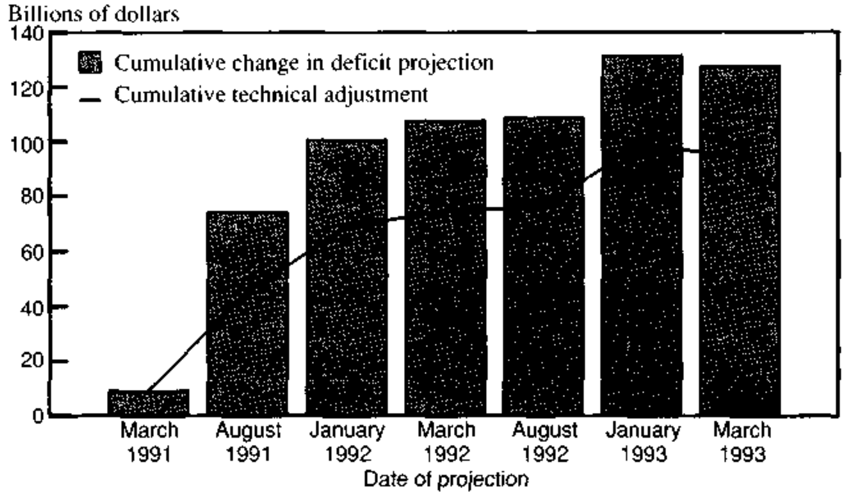
The frustration with the 1990 legislation lies, of course, in deeper structural problems looming just behind this otherwise quite reasonable performance. In particular, it is perfectly clear that realized deficits came close to projections only by chance, and that despite nearly hitting the target in the early years of the plan, no rational case could be made for continued success into 1994 and beyond. Although we would expect the accuracy of the OBRA90 projections to diminish as we moved into its five-year horizon, thus requiring some adjustment in the initial budget plans, the deficit prospects were so far off track that marginal tinkering with the original legislation no longer seemed a viable alternative.

■ OBRA90: The First Three Years
Table 1 illustrates why OBRA90 won few converts despite largely delivering on its promises through FY1993. In the key areas of revenue collection, mandatory spending (primarily entitlement outlays), and discretionary spending (expenditures on defense, infrastructure, education, and so on), the OBRA90 estimates were extremely wide of the mark: Initial projections underestimated the outlay categories by nearly $90 billion and overestimated federal receipts by a whopping $217 billion.

These "mistakes" were effectively masked in the budget totals by fortuitous offsetting outcomes in other parts of the budget: Falling market interest rates reduced net interest payments below anticipated levels. Foreign contributions for Operation Desert Storm provided a windfall in offsetting receipts, a category that under normal circumstances primarily comprises retirement fund contributions within the federal government and voluntary Medicare premium payments. Most important, however, was the huge difference between the initial 1991 estimates of deposit insurance outlays and the actual totals realized from FY1991 through FY1993.

None of these positive developments — positive from a budgetary perspective, anyway — were expected to continue into the future. Unfortunately, at the time the Clinton administration began developing its first budget, the same could not be said of the bad-news categories listed in table 1. As of January 1993, the CBO foresaw deficits for FY1994–96 approaching some $600 billion more than they had expected immediately after passage of OBRA90. The interesting question is, why?

FIGURE 1 CUMULATIVE CHANGES IN FY1994 DEFICIT PROJECTION



NOTE: All changes are relative to January 1991 projections.
SOURCE: Congressional Budget Office.

In the years since 1991, these changes have mainly been associated with shortfalls in revenue collections, deposit insurance outlays, and higher-than-projected entitlement spending. Although a great deal of attention has been focused on problems in the thrift industry, expected deposit insurance spending for FY1994 — changes in which are designated as technical adjustments by the CBO — has actually fallen since the passage of OBRA90, therefore playing no real role in the worsening outlook.

The same cannot be said for entitlement outlays and tax collections. In fact, the difference between the current estimate of the FY1994 deficit and the level expected at the beginning of 1991 is almost exactly equal to the difference in technical adjustments to these two budget items.[4]

■ Deconstructing the End of OBRA90

As part of its ongoing analytical responsibilities, the CBO regularly provides a breakdown of the sources of changes in deficit projections. These sources are broadly divided into three major categories: economic changes, technical changes, and policy changes.

As implied by the terminology, economic changes result from shifts in general economic conditions relative to those expected at the time the projection was made. For example, higher-than-expected real economic growth results in higher-than-expected revenue collections, and hence lower-than-expected deficits.

Technical changes incorporate all adjustments that are not related to explicit policy changes or to estimates of the effects of variations in the economic environment. Recent examples of important technical modifications include lower-than-anticipated deposit insurance outlays, higher-than-expected health care outlays, and lower tax collections than can be explained on the basis of the weak economy alone.

In fact, these technical factors loom large in the post-OBRA90 story. As illustrated by figure 1, nearly 76 percent of the cumulative rise in the FY1994 deficit projections from January 1991 to January 1993 resulted from technical revisions in revenue and outlay totals. While it is true that, prior to OBRA93, policy and economic factors played a role in the worsening outlook for this year's deficit (unexpected weakness in the macroeconomy was certainly a contributing factor), it is clear from figure 1 that most of the upward increase in the projected FY1994 deficit is directly traceable to technical adjustments.

■ What's in a Technical Adjustment?

We might think of technical changes in deficit projections, along with economic adjustments, as a measure of policymakers' luck: Such changes capture factors that are not a direct result of deliberate policy choices. While this interpretation certainly overstates the case — many technical factors involve government policy of some sort, even if that policy is one of benign neglect — technical changes in deficit projections primarily involve the effects of events that are, for the most part, unanticipated.

■ OBRA93: Have Our Fortunes Turned?

These observations effectively mean that the undoing of OBRA90 was a result of miscalculations *that cannot be directly accounted for by legislation or by changing economic conditions.* The real lesson of this history is that the budgetary safeguards of OBRA90 were insufficient to the task of surviving shocks that we could not fully control before the fact and could little understand after the fact.

It is true that our best projections suggest that, for the next several years, OBRA93 will reduce deficit totals below what they otherwise would have been. However, even with the legislation's budget corrections, deficits over the next three years will be almost three times as large as the levels suggested by our best projections following passage of OBRA90.

It is further true that prospects for economic growth are decidedly rosier in 1994 than they were in 1991. However, the very fact that the fiscal strategies implemented in 1993 are so similar to those adopted in 1990 is just cause to suspect our understanding of the short-run nexus of budget policy and macroeconomic activity. Thus, the burden of proof is on those who would claim that in OBRA93 we have averted the potential for near-term economic weakness.

Finally, it is also true that, while technical problems with the OBRA90 forecasts began to manifest themselves almost at once, policy, economic, *and* technical factors have all served to improve the budget outlook.[5] However, the largest part of the nonpolicy revisions in deficit forecasts since last January have been further fortuitous reductions in estimated deposit insurance outlays, stemming from a general improvement in the economic well-being of the thrift industry. This budget improvement, by its nature, is nonrecurring.

Most important, OBRA93 has not changed the OBRA90 budget mechanisms that experience has proven incapable of ensuring an adequate response to adverse, and unanticipated, fiscal developments. Maybe our luck has changed. Maybe our future surprises will, like this year's, all be good ones. But maybe not, and a roll of the dice seems an inadequate basis for sound policy.

■ The Next Step

OBRA90 was not without its accomplishments. In particular, the legislated caps on discretionary spending for FY1991–95 have exerted real discipline on this part of the budget, which includes most expenditures subject to the annual appropriations process.[6] Wisely, Congress and the President chose to leave the OBRA90 spending limits in place and to extend the discretionary cap concept through FY1998. The impact of this approach is obvious in the administration's FY1995 budget proposal: The spending limits have forced the President to propose significant reductions in many discretionary programs in order to accommodate favored spending increases in others.

OBRA93, like OBRA90 before it, also contains pay-as-you-go restrictions on mandatory spending that require new entitlement programs to be financed with added revenues or offsetting spending reductions. However, these requirements do not address the issue of escalating costs in existing programs, which, as we have identified, were a substantial contributor to the perceived failure of OBRA90.

There is a clear political understanding of this problem, manifested in both the administration's health care plan and the President's executive order to establish the Bipartisan Commission on Entitlement Reform. Although the ultimate health care package that comes out of Congress, or the eventual results of executive orders, may not prove to be the Holy Grail of budget reform, some mechanism to require ex post discipline on existing entitlement obligations is clearly necessary. In addition, meaningful fiscal policy reform will require establishing a framework to address the broader problems of entitlement spending, such as implied redistributions of wealth across and within generations.

The ability of OBRA93 to deliver deficit reduction also depends critically on meeting estimated revenue paths: Almost half of the projected decline in federal red ink for FY1994 and FY1995 is attributed to the legislation's tax increases. Unfortunately, as we have seen, the recent record in this area is less than stellar. We believe that this stems from fundamental weakness in the way policy is analyzed in typical budget exercises, which for the most part ignore the sensitivity of economic behavior to changes in taxation. A large amount of evidence has now accumulated indicating that these behavioral effects are substantial, a fact that does not generally bode well for a successful run over OBRA93's horizon.[7]

This is not to say that deficits will fail to decline over the short term. The improving economy alone should prove a salve to some of the budgetary ailments of recent years. However, current law is no cure for the more basic problems that OBRA90 exposed all too clearly. Without a budget process that more effectively links outcomes with objectives, our luck will, sooner or later, surely run out.

Footnotes

1. This figure is the difference between the CBO's March 1993 and January 1994 deficit projections (total deficit assuming discretionary caps). Throughout this article, all projections are from the CBO. January projections are taken from *The Economic and Budget Outlook*, published annually. July, August, and September projections are taken from midyear updates of the same publication. Except for 1993, March figures are from the annual *Analysis of the President's Budget Proposals*. The March 1993 projections were obtained by request from the CBO's Projections Unit.

2. Policy analysts often draw a distinction between a "projection" and a "forecast." Both terms, by definition, refer to estimates of economic outcomes under particular assumptions about policy. However, unlike forecasts, projections are not necessarily based on the belief that the assumed policies will be realized. Although this somewhat subtle distinction can be important, the terms will be used interchangeably here.

3. In this article, we take at face value the implication that deficit reduction per se is a sensible goal of public policy. We do not, however, subscribe to this position. Specifically, it is our belief that the essential issues of fiscal policy involve the allocative consequences of government command over real resources, including the level of resource absorption, the distribution of transfers, and the manner in which these activities are financed. Conceptually, the measured deficit associated with any particular configuration of these activities is arbitrary. For a more detailed discussion of some of these issues, see Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A New Approach to Fiscal Policy Evaluation," Federal Reserve Bank of Cleveland, *Economic Commentary*, November 15, 1991. See also Laurence J. Kotlikoff, *Generational Accounts: Knowing Who Pays, and When, For What We Spend*. New York: The Free Press, 1992.

4. It is true that reestimates of deposit insurance outlays for FY1995–96 have, since 1991, contributed to higher deficit forecasts. However, adverse revisions in the outlook for entitlements and revenues remain the largest source of upward revisions in projected deficits for these two years.

5. The economic assumptions underlying the Clinton administration's original budget projections were pessimistic by design. For example, the budget calculations were based on an assumed GDP growth path that declined to a meager 1.8 percent by 1998. In light of this, improvements in the deficit outlook were to be expected as the administration brought its own economic assumptions more in line with mainstream forecasts.

6. The discretionary spending caps are formally a part of the Budget Enforcement Act of 1990.

7. See, for instance, Lawrence B. Lindsey, *The Growth Experiment: How the New Tax Policy Is Transforming the U.S. Economy*, New York: Basic Books, 1990; Daniel R. Feenberg and James M. Poterba, "Income Inequality and the Incomes of High-Income Taxpayers: Evidence from Tax Returns," in James M. Poterba, ed., *Tax Policy and the Economy*, vol. 7, Cambridge, Mass.: National Bureau of Economic Research and MIT Press, 1993, pp. 145–77; Martin Feldstein, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," Cambridge, Mass.: National Bureau of Economic Research Working Paper No. 4496, October 1993; and David Altig and Charles T. Carlstrom, "Marginal Tax Rates, Income Inequality, and the Laffer Curve: A Quantitative–Theoretic Welfare Analysis," Federal Reserve Bank of Cleveland, Working Paper (forthcoming).

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