Successful Consolidation of the American Budget – an Example for Europe?

In 1998 the overall US government budget was balanced for the first time since the late 1970s. The efforts at fiscal consolidation made by US fiscal policy, which have focused largely on the federal budget, have thus been extremely successful in the 1990s.

On the other hand, American fiscal policy accepted substantial deficits over a period of many years, and the consolidation of government budgets has been successful only in the wake of the long and robust cyclical upturn. Thus the fiscal consolidation strategy has differed fundamentally from that pursued in most European countries, which have often had pro-cyclical effects during the 1980s and 1990s, and thus prevented a sustained upturn from taking hold.

Many observers have seen US fiscal policy as a model because government accounts for a far lower proportion of total economic activities than, for example, in Germany. Total government spending, for instance, currently accounts for almost 50% of nominal GDP in Germany, whereas in the USA, including gross public investment, it represents just 33%. However, direct international comparison of total governmental activities is subject to serious problems. The higher relative figure in Germany does not result primarily from stronger public-sector claims on macroeconomic resources but, rather, largely reflects the fact that the social security systems are organised in different ways in the two countries. Whereas, for instance, the health service in the USA is largely part of the private business sector, the statutory health insurance system in Germany is booked under the public sector. Similar considerations apply to the pension insurance systems.

The aim of this report is to analyse the development of public-sector revenue, expenditure and deficits/surpluses in the USA, however, and less to make an international comparison. Consequently, unless indicated otherwise, the phenomena are studied largely on the basis of the data published in the Survey of Current Business, particularly of the federal budget. For this reason the figures on receipts, expenditure and deficits as a proportion of output cannot be directly compared to those for Germany.

Fiscal consolidation strategies in the USA

When, in the mid-1980s, the US federal government budget recorded growing deficits, primarily because of the substantial increase in defence spending, and the threat of a major burden of interest payments in the future became very real, top priority on the economic-policy agenda was quickly given to the goal of balancing the government budget. Fiscal policy was subjected to binding rules, the aim of which was to underpin the credibility of the efforts towards consolidation. Under the Gramm-Rudman-Hollings Act the federal budget was to be brought into balance within six years (1985 to 1991), by setting statutory targets for the deficit. The targets referred exclusively to the current federal deficit; in other words, public investment and other capital transactions were excluded. The targets consisted of figures for the absolute level of the deficit. If these limits were exceeded by more than 10 billion dollars in the budget projections, corresponding generalised cuts in spending were automatically to apply (sequester).[1]

The aim of this law was to exert pressure in order to limit spending growth. For the government had to justify measures that involved additional spending against the background of the forecasts for the deficit. However, although the federal deficits were reduced, the goal of balancing the federal budget was not achieved.

A fundamental weakness of this law was the lack of attention it paid to the state of the business cycle. Cyclical factors only played a role to the extent that the budget plan was based on a growth forecast. Thus by assuming more favourable cyclical trends, a more favourable budget prognosis could be drawn up. In this way it was possible to avoid cutting spending at the start of a fiscal year. And indeed, most forecasts of the budget deficits proved far too optimistic.[2] Nor did the law make any provision for a cyclical downturn. Even if economic growth weakened, the requirement to reduce spending – and thus to set a pro-cyclical budget – still applied. This concept was not rigorously followed, however. Consequently, the federal budget deficit rose once more when economic growth began to weaken towards the end of the 1980s.

In the autumn of 1990 a new strategy was adopted to balance the budget, in the form of the 'Omnibus Budget Reconciliation Act'. The focus was then put on strict control of expenditure, without setting a concrete deficit target.[3] This law distinguishes between discretionary

[1] For a detailed description see OECD, 'Economic Survey USA 1988/89', 1988.

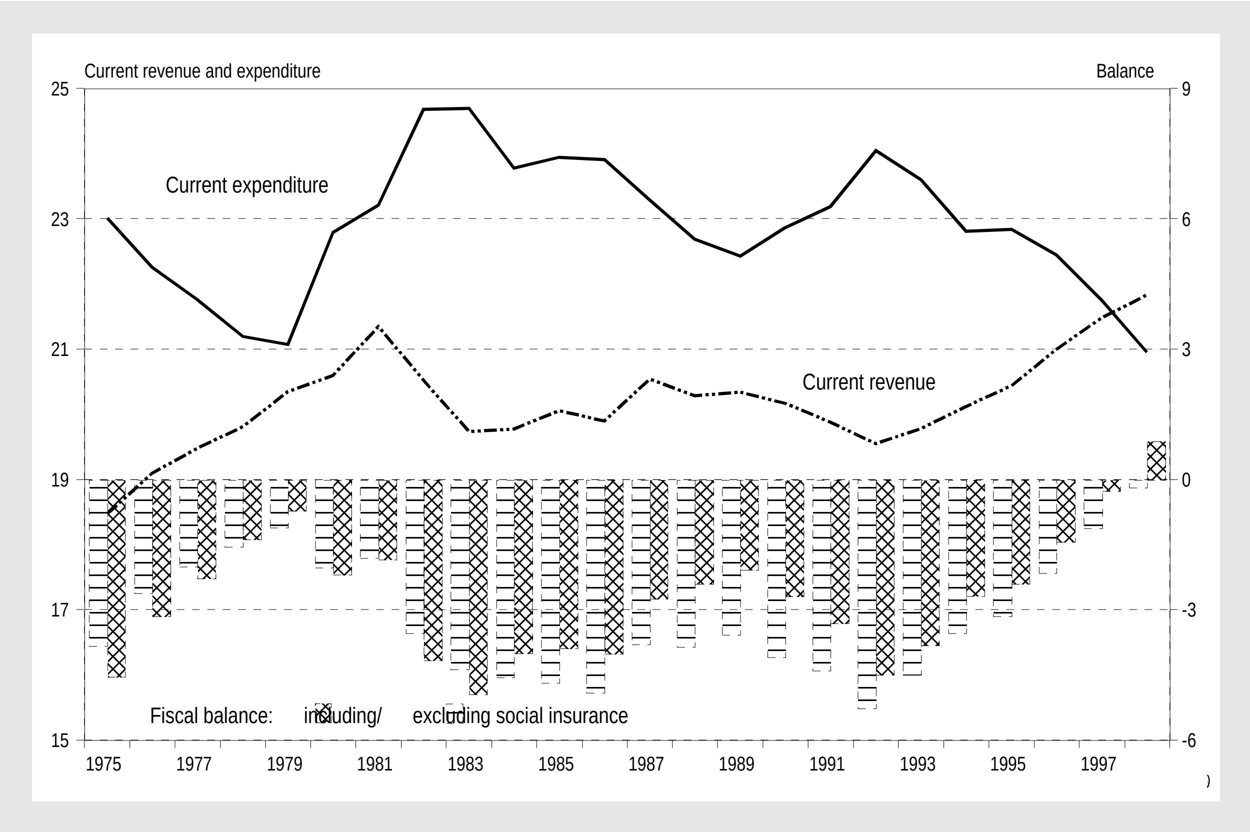
[2] See the comparison between prognoses and ex post figures in OECD, 'Economic Survey USA 1990/91', 1991.

[3] See OECD (1991), loc. cit.

Figure 1

Current Revenue and Expenditure and Fiscal Balance of the US Federal Budget[1]

as a % of GDP



1 Including that part of the social insurance system organised at federal level.
Sources: Survey of Current Business; DIW calculations.

spending, the level of which is planned anew every year, such as defence spending, and mandatory expenditure, such as that on the Medicare Programme in support of health insurance for the elderly.

Under this new law a ceiling is only applied to real discretionary spending, differentiated by category. If the maximum levels are exceeded, without this being offset financially by tax increases or cuts in other spending areas, spending must automatically be set at a lower planned level or reduced in those areas of spending in which the limits were not adhered to. Under this law there are no restrictions on mandatory expenditure. Only in the case of legal amendments do the same rules apply as to discretionary spending: any spending increase on this basis must be financed; it must not lead to an increase in the deficit.

This new concept differs from the preceding law in one central respect. In a cyclical downturn the government budget deficit is permitted to increase to the extent that the increase results from the effects of the built-in stabilisers. During an economic boom, on the other hand, the deficit must narrow, as the favourable situation on the revenue side may not be used to finance additional spending, but rather may only be used for consolidation. Consequently, this strategy implies a deficit that 'breathes' in rhythm with the business cycle, and one that, moreover, thanks to its anti-cyclical orientation, aims to stabilise the business cycle.

Current deficit trends in the 1990s

In the course of the favourable cyclical trend during the second half of the 1980s, US fiscal policy was initially able to make rapid progress towards balancing the budget. Current expenditure by federal government declined markedly as a share of output, whereas there was little change in the revenue share, despite relatively rapid economic growth, because of cuts in tax rates. The federal government deficit, including social insurance, fell to 2.1% of nominal GDP in 1989. However, this decline was substantially less than foreseen by the law.

As the economy cooled down towards the end of the 1980s, the deficits widened substantially once more from 1990 (cf. table 1). In 1992 the current federal deficit amounted to more than 5% of nominal GDP, and was actually higher than it had been ten years previously during the preceding recession.

The new legal basis for fiscal policy introduced in the autumn of 1990 has since been the determining factor behind the spending policies of the US federal government. The consolidation of the federal budget occurred against the background of an extremely robust expansion of total output (more than 3% per annum). By 1998 the deficit was virtually negligible. Given the at most slight weakening of economic activity forecast, the federal government is expected to record a budget surplus in 1999. This means that the goal of a balanced budget will be achieved far earlier than had been planned by the American government and shows that the legally binding restrictions have been effective.

As a result of this legislation, real discretionary expenditure grew only weakly in the course of 1990s (cf. table 1). Mandatory spending, on the other hand, expanded more rapidly. Transfer payments within the framework of the Medicare Programme, for example, continued to rise sharply, reflecting the changing age composition of the population and rising health-care costs. Overall, public spending as a proportion of GDP fell markedly. What is striking is that this contribution to consolidation was not brought about by reducing transfer payments, for instance by tightening legal entitlements, but by limiting government consumption.

Developments on the revenue side also made a significant contribution to consolidating the federal budget. Since the end of the recession, federal government revenue has increased substantially as a share of output. This partly reflects the tax increases in 1993 that served to intensify the impact of the income tax progression. What was decisive, however, was the strong growth of the tax base in the wake of the sustained and dynamic cyclical upturn. This led to a considerable rise in revenue from direct taxes.

The impact of US fiscal policy on economic activity

The success of American efforts at budgetary consolidation have been largely based on the dynamic economic growth of the economy; equally, though, public sector spending and revenue behaviour have also had a perceptible influence on cyclical trends in the US economy.

When analysing the impact of government deficits on economic trends, it must be recalled that shocks, whatever their origin, influence economic developments not only in the short run, but also over the longer run.[4] If fiscal policy stabilises aggregate demand by providing a positive demand impulse, and thus counters negative shocks, the trend rate of growth is higher. Conversely, a pro-cyclical fiscal policy can lead to a persistent weakening of economic growth, and thus to entrenched unemployment. This is particularly the case when the efforts at fiscal consolidation are made when the recovery phase is just beginning.

In order to analyse the impact of US fiscal policy on the business cycle, positive or negative demand impulses were set against the fluctuations in the business cycle, as represented by changes in capacity utilisation.[5] The demand impulses were calculated by extrapolating the revenue of and expenditure by government and the social insurance institutions actually recorded in the previous year by the rate of growth of potential output. These values represent, as it were, the cyclically neutral reference line. Positive demand impulses occur when actual receipts are lower and/or spending higher than the extrapolated values. Net transfers to and from the rest of the world and interest payments were not considered. Within this concept, not only discretionary changes in government budgets, but also cyclically induced fluctuations, i.e. the built-in stabilisers, are considered to be relevant to demand.

As the upper left-hand graph in figure 2 shows, in the USA government demand impulses and capacity utilisation exhibit a contrary pattern over time. In phases in which productive capacity was underutilised, this was offset by positive government demand impulses. As the economy recovered, the positive impulses grew weaker, or even turned negative. In recent years US fiscal policy has been shown to have reacted appropriately to changes in the cyclical situation. In 1989 even a slight cyclical weakening led to expansionary demand impulses, following a period in which fiscal policy had been rather restrictive. This shift from a restrictive to an expansionary effect was largely due to the built-in stabilisers in the area of mandatory spending. Discretionary demand-management programmes, on the other hand, were not implemented, in accordance with legal requirements. The statutory limits on spending subsequently meant that the favourable trend on the revenue side could be used during the upturn to reduce the current deficit. At the same time this helped prevent the economy overheating.

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[4] See John Y. Campbell and N. Gregory Mankiw, 'International Evidence on the Persistence of Economic Fluctuations', *Journal of Monetary Economics*, March 1988, 23(2), pp. 319–333.

[5] This calculation for the USA was based on OECD data. In order to permit international comparison, in this case definitions were selected that correspond to those for Germany.

Table 1

US Federal Government[1] Expenditure and Revenue, 1989 to 1998

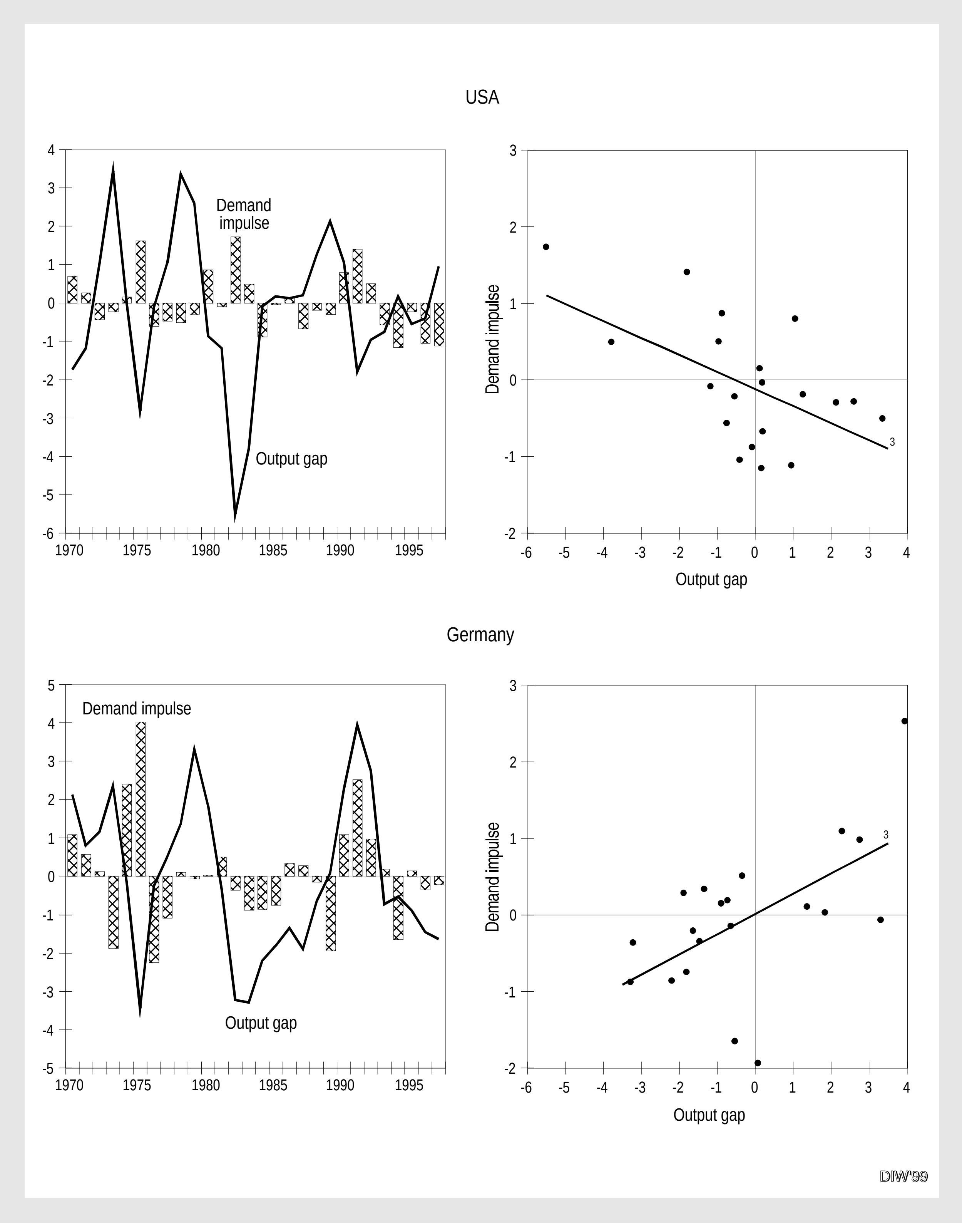
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
					in US–$ billion					
Indirect taxes	50.6	52.6	63.0	64.2	68.7	80.4	77.9	75.1	79.1	81.8
Direct taxes	579.2	602.3	585.2	608.0	659.3	717.1	783.2	877.4	976.4	1 054.9
Social security contributions	437.1	461.1	482.6	507.1	527.3	557.1	582.4	610.2	647.0	681.4
Income from entrepreneurial activity and property	26.7	28.3	26.6	22.0	21.8	22.7	25.1	24.0	22.4	22.1
Other revenue	12.4	13.8	18.4	19.1	19.9	20.1	16.8	22.0	17.3	17.1
Total revenue	1 106.0	1 158.1	1 175.8	1 220.4	1 297.0	1 397.4	1 485.4	1 608.7	1 742.2	1 857.5
Government consumption	405.2	426.6	445.9	451.0	447.3	443.2	442.8	450.9	460.4	457.9
Social security expend., public sector pensions etc.	460.3	500.0	550.1	608.5	642.6	666.6	708.9	748.0	779.2	802.2
Transfers abroad (net)	11.4	13.3	–27.9	16.6	17.3	16.4	11.4	16.2	12.7	10.0
Interest payments	193.4	208.2	219.3	217.9	214.5	222.7	249.9	252.4	253.6	249.8
Subsidies	30.8	32.4	30.8	35.1	40.1	35.9	34.8	32.7	32.5	33.6
Federal grant to state and local govt.	118.2	132.4	153.4	172.2	185.8	199.2	212.0	218.9	225.0	229.0
Total expenditure	1 219.3	1 312.9	1 371.6	1 501.3	1 547.6	1 584.0	1 659.8	1 719.1	1 763.4	1 782.5
Federal government financial balance (current revenue minus current spending)	–113.3	–154.8	–195.8	–280.9	–250.6	–186.6	–174.4	–110.4	–21.2	75.0
Federal budget	–194.2	–234.8	–261.0	–329.3	–295.2	–245.8	–229.1	–164.9	–91.4	–15.4
Social insurance	80.9	80.1	65.0	48.4	44.6	59.2	54.7	54.6	70.3	90.5
					change on previous year in %					
Indirect taxes	–1.0	4.0	19.8	1.9	7.0	17.0	–3.1	–3.6	5.3	3.5
Direct taxes	10.5	4.0	–2.8	3.9	8.4	8.8	9.2	12.0	11.3	8.0
Social security contributions	6.4	5.5	4.7	5.1	4.0	5.7	4.5	4.8	6.0	5.3
Income from entrepreneurial activity and property	–0.7	6.0	–6.0	–17.3	–0.9	4.1	10.6	–4.4	–6.7	–1.2
Other revenue	12.7	11.3	33.3	3.8	4.2	1.0	–16.4	31.0	–21.4	–1.0
Total revenue	8.0	4.7	1.5	3.8	6.3	7.7	6.3	8.3	8.3	6.6
Government consumption	4.5	5.3	4.5	1.1	–0.8	–0.9	–0.1	1.8	2.1	–0.6
Social security expend., public sector pensions etc.	8.1	8.6	10.0	10.6	5.6	3.7	6.3	5.5	4.2	2.9
Transfers abroad (net)	0.0	16.7	–	–	4.2	–5.2	–30.5	42.1	–21.6	–21.0
Interest payments	10.3	7.7	5.3	–0.6	–1.6	3.8	12.2	1.0	0.5	–1.5
Subsidies	–8.9	5.2	–4.9	14.0	14.2	–10.5	–3.1	–6.0	–0.6	3.5
Federal grant to state and local govt.	6.3	12.0	15.9	12.3	7.9	7.2	6.4	3.3	2.8	1.8
Total expenditure	6.5	7.7	4.5	9.5	3.1	2.4	4.8	3.6	2.6	1.1
memo item: real government consumption expenditure	2.7	2.3	1.0	–0.1	–0.3	0.4	–0.3	0.7	1.3	0.7
					as a % of nominal GDP					
Indirect taxes	0.9	0.9	1.1	1.0	1.0	1.2	1.1	1.0	1.0	1.0
Direct taxes	10.6	10.5	9.9	9.7	10.1	10.3	10.8	11.5	12.0	12.4
Social security contributions	8.0	8.0	8.2	8.1	8.0	8.0	8.0	8.0	8.0	8.0
Income from entrepreneurial activity and property	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Other revenue	0.2	0.2	0.3	0.3	0.3	0.3	0.2	0.3	0.2	0.2
Total revenue	20.3	20.2	19.9	19.5	19.8	20.1	20.4	21.0	21.5	21.8
Government consumption	7.5	7.4	7.5	7.2	6.8	6.4	6.1	5.9	5.7	5.4
Social security expend., public sector pensions etc.	8.5	8.7	9.3	9.7	9.8	9.6	9.8	9.8	9.6	9.4
Transfers abroad (net)	0.2	0.2	–0.5	0.3	0.3	0.2	0.2	0.2	0.2	0.1
Interest payments	3.6	3.6	3.7	3.5	3.3	3.2	3.4	3.3	3.1	2.9
Subsidies	0.6	0.6	0.5	0.6	0.6	0.5	0.5	0.4	0.4	0.4
Federal grant to state and local govt.	2.2	2.3	2.6	2.8	2.8	2.9	2.9	2.9	2.8	2.7
Total expenditure	22.4	22.9	23.2	24.0	23.6	22.8	22.8	22.4	21.7	20.9
Federal government financial balance (current revenue minus current spending)	–2.1	–2.7	–3.3	–4.5	–3.8	–2.7	–2.4	–1.4	–0.3	0.9
Federal budget	–3.6	–4.1	–4.4	–5.3	–4.5	–3.5	–3.2	–2.2	–1.1	–0.2
Social insurance	1.5	1.4	1.1	0.8	0.7	0.9	0.8	0.7	0.9	1.1
memo item: government financial balance on national accounting	–1.7	–2.7	–3.3	–4.4	–3.6	–2.3	–1.4	–0.4	0.4	1.6

1 Incl. parts of the social security system which are organised by the federal government.

Sources: Survey of Current Business http://www.bea.doc.gov/bea/uguide.htm#_1_16; OECD Economic Outlook; DIW calculations.

Figure 2

Fiscal Demand Impulses and Output Gap as % of GDP, 1970 to 1997 and 1978 to 1997



1 Deviations between spending/revenue affecting domestic demand and the 'neutrality line' extrapolated using potential output as a % of nominal GDP. — 2 Difference between current GDP and potential output as a % of GDP (output gap). — 3 The lines mark the average correlation between the two variables over the observation period.
Sources: Survey of Current Business; DIW calculations.

All in all, fiscal policy in the USA was anti-cyclical and exerted a stabilising impact on economic trends throughout the period under consideration. The negative relationship is revealed even in a simple correlation between demand impulse and capacity utilisation (cf. figure 2). This outcome reflects both the strategy of accepting budget deficits in the recessionary phase, if necessary leading to changes in legislation, and the persistent restrictive impact of US fiscal policy during economic boom phases, when consolidation was once again given top priority. Yet the restrictive effects were never so severe that they endangered the upturn. Such a trend is, however, conditional on other policy areas, especially monetary policy, providing consistent support for economic expansion.

Comparison with Germany

Economic policy in Germany differs fundamentally from that in the USA. At the end of the 1970s Germany changed its policy stance (bottom left-hand graph in figure 2). Prior to that, as in the USA, there was a negative correlation between fiscal-policy impulses and the business cycle, whereas since then fiscal policy in Germany has been rather pro-cyclical in its orientation. The 1980s were characterised virtually consistently by efforts to consolidate government budgets. These were maintained even in the recession of 1982. In 1990, on the other hand, the third stage of the tax reform being implemented at the time coincided with the upturn that preceded German unification, leading to an acceleration of economic growth. The substantial tax cuts led to a marked increase in the income at the disposal of west German private households. As a result, in the course of 1990 private consumption expanded perceptibly, so that fiscal policy provided an additional stimulus to an already booming economy. The increase in budget deficits in the wake of German unification exacerbated this process still further.

As government debt accumulated, however, the government soon adopted a consolidatory course. In 1993, a year marked by recession, fiscal policy was slightly expansionary, primarily thanks to the built-in stabilisers, whereas in 1994 spending cuts and tax increases exerted a restrictive effect of around DM 55 billion. This put severe pressure on the economic recovery, which had only just begun. The efforts at consolidation, which were intensified after the Maastricht Treaty, constituted an obstacle to macroeconomic development over a period lasting several years. Yet ironically, because of this the goal of easing the burden on government budgets in a sustainable way has not been achieved.

Lessons for Europe

In the light of developments in the USA, the strategy adopted by the EMU countries to consolidate their government budgets appears questionable. Decisive for the success of consolidation efforts in the USA was that the strategy was targeted at the root cause of the problem of public debt, namely the tendency for government to introduce additional spending programmes when tax revenues are flowing freely. By contrast, the Maastricht Treaty and the Stability and Growth Act have set a maximum limit on the magnitude of the budget deficit. Although this obligation is suspended in the case of a serious recession, this waiver only applies if output declines by more than 2% in a single year. Yet this precondition is so restrictive that in the past virtually no infringement of the ceiling would have been permissible. Germany has never experienced such a serious contraction throughout the entire post-war period. On the other hand, apart from the more general objective of a balanced budget in the longer run, neither the Treaty of Maastricht nor the Dublin Stability Pact contain provisions on restricting expenditure in periods in which the economy is growing strongly. Consequently, European efforts to consolidate public finances are based on a philosophy in line with that underpinning the Gramm-Rudman-Hollings Act, one which was recognised in the USA to be inappropriate and which was consequently replaced. A more promising approach would be to reduce the propensity to increase expenditure when the economy is growing dynamically.

The basic lesson that needs to be learnt from American experience is that fiscal consolidation can only be achieved under two conditions. The first requirement is a robust and sustained upturn. In order to achieve this, other areas of economic policy, especially monetary policy, must adopt a clearly expansionary stance. Secondly, governments should then – i.e. in the context of an economic upturn – adopt a rather restrictive stance on the spending side, i.e. aim to reduce public spending significantly as a share of output. At heart this means that, at the end of the day, government cannot 'save itself' from a budget deficit, but rather must 'grow out of it'.

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