Economic Research Department

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Fiscal Stimulus, Deficit and the Challenges Ahead

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- **Fiscal stimulus prevents a deeper recession**
- **However, it will amplify the budget deficit**
- **Rising healthcare costs and aging population will drive the public debt to unsustainable levels**
- **Policy action is imperative; the sooner the better**

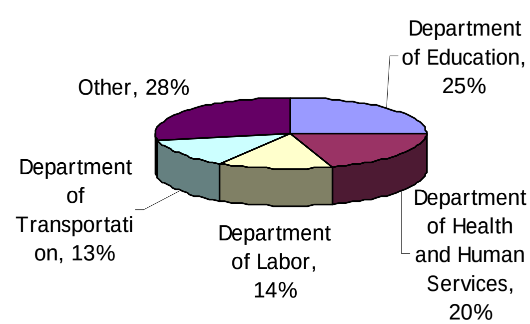
Seven Months of Stimulus: Where Have the Funds Gone?

More than seven months have passed since the Obama administration passed the American Recovery and Reinvestment Act of 2009 in response to the deepening recession. The act provides a monumental $787bn in funds with the goal of stimulating growth by enacting measures that will save and create more than 3.5 million jobs over the next two years, stimulate near-term demand through tax cuts and credits and encourage investment to drive the future by providing incentives for innovation in industries such as green energy, healthcare and transportation.

As of September 9, 2009, the government has made $217.0bn available to twenty-eight government agencies and $89.1bn, equivalent to 41%, has been paid out. Although the greatest amount of money, $55.5bn, has been made available to the Department of Education (DOE), the most has been paid out to the Department of Health and Human Services (HHS). Of the total $29.2bn paid out to HHS, 98% has gone to the states as grants to increase their Medicaid funding. In addition, that amount is equal to 33% of the total funds paid out to all agencies. This high percentage was to be expected since two-thirds of the stimulus funds will be directed towards Medicaid in 2009.

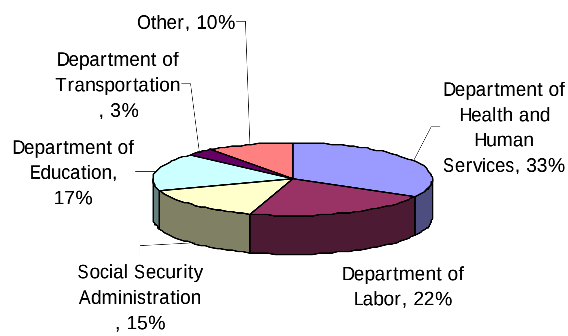
Following HHS, the Department of Labor (DOL) has received 22%, $19.7bn, of the total paid-out funds, which have primarily gone to programs that increase funding for unemployment insurance. Furthermore, $13.2bn, 15% of the total, has gone to the Social Security Administration, where it was used to make one-time economic recovery payments. The SSA has used 100% of the funds made available to it. In addition, the DOE has received 17%, $15.5bn, of the funds paid-out, which have gone to the State Fiscal Stabilization

Funds Made Available by Agency
(% of Total, Total = $217.0bn)



Source: www.recovery.gov

Funds Paid Out by Agency
(% of Total, Total = $89.1bn)



Source: www.recovery.gov

Funds. Lastly, the Department of Transportation (DOT) has only received $2.4B, 8% of the funds available to it and 3% of the total funds paid-out.

In total, $280bn of the funds paid out to federal agencies will be filtered through to the states. According to GAO projections, states are expected to receive $48.9bn in fiscal year 2009. As of September 9, 2009, $182.7bn has been made available and $73.3bn has been paid-out. States are on track to reach and may even surpass the GAO's forecast, which indicates that states are actively taking advantage of the program. To date, 37% of the paid-out funds have gone to California ($12.9bn), New York ($6.3bn), Illinois ($4.1bn) and Texas ($3.5bn).

Furthermore, the administration also allocated $288bn for tax benefits to put more money into individual's hands and to stimulate some sectors such as housing and autos. As of August 4, 2009, more than $53bn in tax benefits has been paid out.

To date, the paid-out funds have been targeted towards immediate economic support programs such as Medicaid, unemployment insurance, Social Security and tax incentives, rather than investment projects. The reasoning behind the structure of the policy response was to limit the depth of the economic downturn by putting money directly into the pockets of those who can inject it more readily into the economy. Recent economic indicators have suggested that the worst of the downward adjustment is over, thus, the next target of the fiscal stimulus will be to achieve sustained economic growth. Although we expect the fiscal stimulus to cushion against the depth of the crisis, it will have a significant impact on the fiscal balance.

Fiscal sustainability

Under current legislation, debt held by the public is heading towards an unsustainable path. The fiscal stimulus, an aging population and rising health care costs will exert significant pressures on the federal budget over the mid- and long-run.

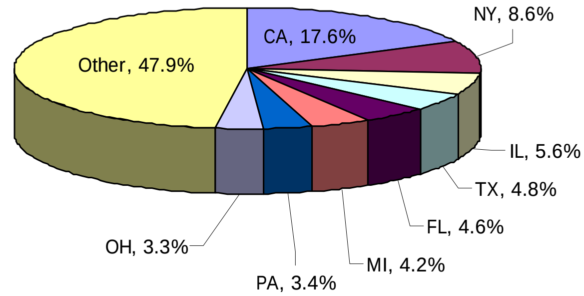
Sustainability problems occur when a government moves towards excessive debt accumulation. Massive government debt reduces the amount of savings in the economy that would otherwise be used to finance private investment (crowding-out effect). It could also affect net exports if the exchange rate appreciates as a result of higher interest rates and net capital inflows. In addition, as interest costs rise, spending for other projects diminishes while the government loses flexibility to allocate resources to unexpected situations.

To assure fiscal sustainability, the government should seek a fiscal policy that guarantees that the ratio of debt to GDP converges back to a pre-determined level consistent with long-run stability.

Short-run imbalances

Massive debt accumulation in the short-run has to do with the government's response to the ongoing economic contraction and military operations. In our baseline, the fiscal package will bring debt

Funds Paid-Out by State
(% of total, total = $73.3bn)



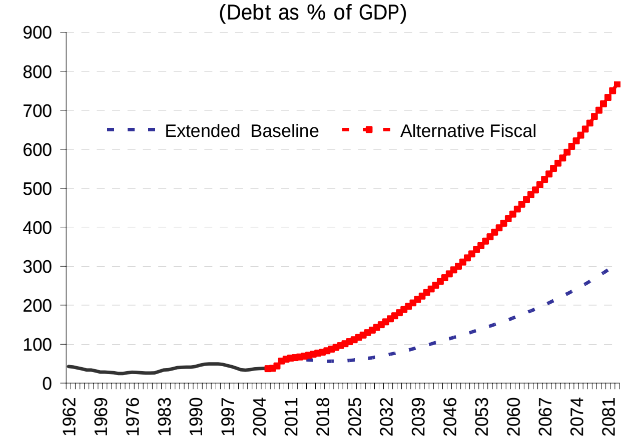
Source: www.recovery.gov

Fiscal Outlook (% of GDP)

	Public Deficit	Debt held by the public
2008	-3.2	40.2
2009	**-11.2**	**54.6**
2010	**-10.4**	**65.2**
2011	**-7.8**	**70.0**
2012	**-5.3**	**72.3**

Source: CBO and BBVA ERD forecasts

Fiscal sustainability
(Debt as % of GDP)



Source: CBO

held by the public from 40.2% of GDP in 2008 to 65.2% in 2010. Debt will increase steadily thereafter, reaching 72.3% of GDP by 2012.

During recessions, tax revenues fall due to job losses, lower consumer spending, declining business profitability and lower asset prices; meanwhile, government spending increases from automatic stabilizers such as unemployment benefits that are aimed at cushioning the impact of the recession. To finance the deficit, the government typically has to increase the amount of debt. These developments have been exacerbated by the uniqueness of the current economic recession and the fiscal stimulus package.

This is clearly illustrated with a simple exercise. When we isolate the effect of the business cycle from the deficit, we obtain a measure of how large the balance would have been if revenues and spending had grown by a rate similar to their underlying trend. Our estimates suggest that the underlying deficit will reach 2.5% of GDP in 2009, 8.7 pp less than our current forecast of 11.2%. The underlying deficit would shrink to 0.5% of GDP by 2012 vs. our forecast of 5.3%.

Bringing the deficit back to its underlying trend requires policy actions that increase the amount of revenues and/or reduce spending. However, this may prove difficult and risky during recessions, especially when there are no clear signs of recovery. In today's crisis, economic growth *per se* is not enough to balance the budget. In fact, if we calculate the fiscal balance in a scenario where the 2001 and 2003 tax cuts are extended, the deficit narrows slowly from 11.2% in 2009 to 7.8% in 2012. Thus, while GDP recovery helps to lower the deficit it is not enough to bring it back to its underlying trend.

In the President's FY 2010 budget, the deficit is expected to move closer to its underlying trend over the next decade. This reflects that some provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 are let to expire by the end of 2010.[1] Revenues also increase from the expiration of certain tax provisions in the American Recovery and Reinvestment Act of 2009 and the economic recovery. However, these measures are not enough to guarantee fiscal sustainability in the mid- and long-term because of the substantial increase in interest payments, rising health-care costs and higher burden on social security payments from aging population.

Fiscal imbalances in the long-run

The main source of excessive debt accumulation in the long-run is the increasing cost of Social Security, Medicare and Medicaid caused by an aging population and the fast growth in healthcare costs. According to our estimates, under current legislation, public debt held as a share of GDP will reach 77% in 2020, a level not seen since WWII. Long-run projections are even more striking with debt surpassing 100% of GDP by 2035 and more than 150% by 2050[2].

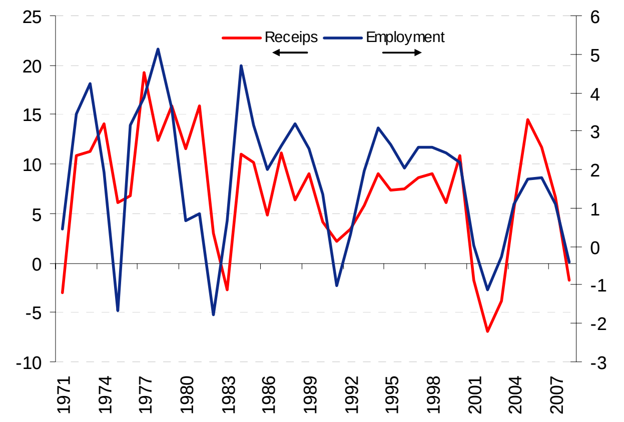
Combined, federal spending on Medicare and Medicaid is expected to grow from 5% of GDP in 2009 to 10% by 2035 and to more than 17%

1 CBO, An Analysis of the President's Budgetary Proposals for Fiscal Year 2010, June 2009, ww.cbo.gov

2 CBO, The Long-Term Budget Outlook, July 2009, www.cbo.gov

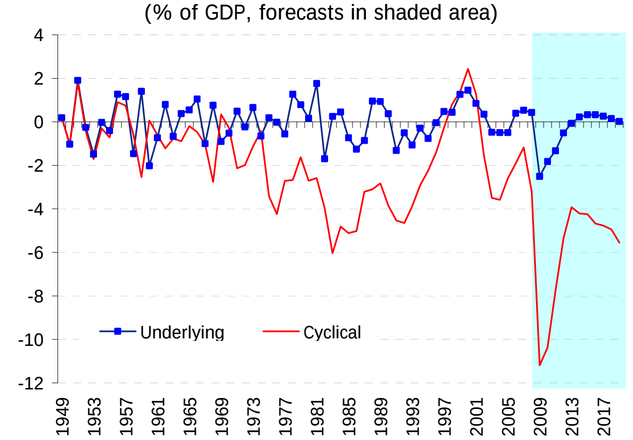
Fiscal Receipts & Employment

(yoy % change)



Fiscal Balance

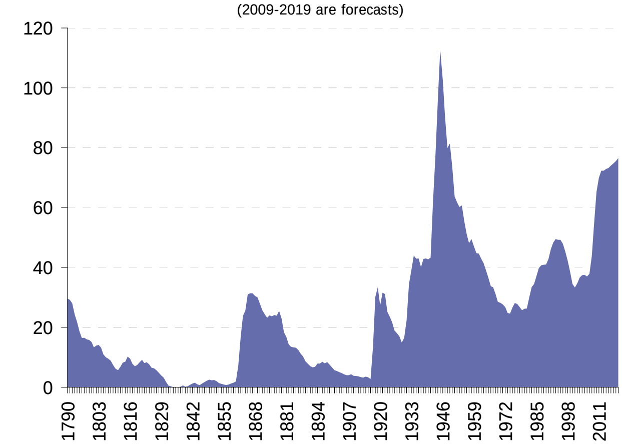
(% of GDP, forecasts in shaded area)



Source: CBO and BBVA ERD

Public Debt as % of GDP

(2009-2019 are forecasts)



Source: Census, OMB and BBVA ERD

by 2080. In addition, the cost of Social Security will rise from 5% of GDP today to 6% in 2035 and will remain constant until 2080. According to CBO, the increase in spending from an aging population accounts for approximately 64% of the projected growth in spending on major entitlements by 2035 of which a large component is related to healthcare. In fact, over the next 20 to 70 years, 56% of the growth in total federal spending can be attributed to healthcare costs.

Massive retirements of baby boomers in the next several years and increasing longevity have begun to put significant pressures on the Social Security Trust Fund. These trends will cause a significant reduction in the ratio of workers to retirees. In 2016, Social Security is projected to pay more benefits than what it receives from payroll taxes[3]. The program will be able to cover the shortage by selling trust fund assets; however in 2037, reserves will be depleted and tax income will only pay for 76% of scheduled benefits. To bring the trust fund into balance, the government would have to inject $3.7 trillion from sources other than payroll taxes. The cost in 2009 dollars of this shortage is $5.3 trillion, which is the amount that the government should have to put into the Trust Fund immediately.

Based on our definition of sustainability, we have calculated a fiscal gap, that is "the extent to which the government would need to immediately and permanently raise tax revenues, cut spending, or use some mix of both to make the government's debt the same size (relative to the size of the economy) at the end of that period as it was at the beginning".[4]

According to our estimates, under current trends the government would have to implement an immediate increase in revenues, cut in spending or a combination of both, by an amount equal to 7.5% of GDP so that the public debt by 2029 could be similar to 2009's. The size of the adjustment is equal to New York's state GDP. The more the government delays, the higher the burden. For instance, if it wants to reduce the debt to 2009 levels by 2049, the adjustment would equal 8.7% of GDP. The government could also trim down the real cost of debt through inflation. For instance, we have calculated that reducing the debt ratio down to 2008 levels by 2025 would imply a 6.5% rate of inflation each year, *ceteris paribus*. However, in practice this is a costly –and improbable- measure as interest rates would increase, inflation expectations deteriorate and potential economic growth diminish.

Need of reforms

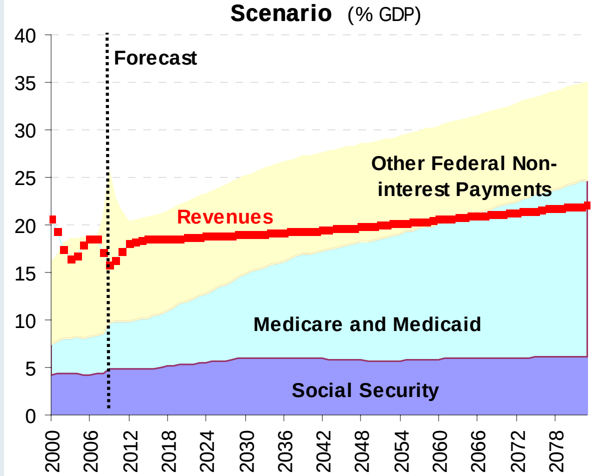
Rising taxes and spending cuts may prove difficult and politically risky during recessions, however, there are other measures that can help to narrow the debt burden.

Social Security: the board of Trustees indicates that Social Security could achieve actuarial balance in the next 75 years if the payroll tax increases immediately from 12.4 to 14.4% or if benefits are reduced 13% or a combination of both. To increases revenue, the government

3 SSA, Status of the Social Security and Medicare Programs 2009, www.socialsecurity.gov

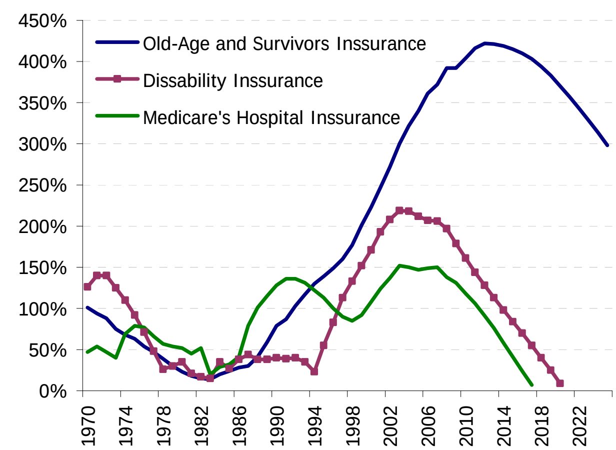
4 CBO, The Long-Term Budget Outlook, Op. Cit., p. 8.

Federal Revenues and Noninterest Spending, by Category, Under CBO's Alternative Fiscal Scenario (% GDP)



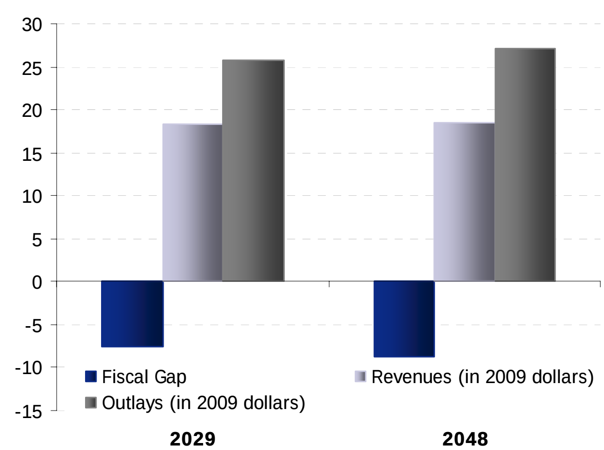
Source: CBO

OASI, DI, and HI Trust Fund Ratios
(Assets as a percentage of annual expenditures)



Source: Social Security Administration

Fiscal Gap
(% share of GDP)



Source: BBVA ERD with CBO data

can also raise the cap of taxable earnings (currently at $106,800), increase taxes on Social Security benefits and/or invest a fraction of the trust fund in financial markets. In addition, in order to reduce the cost of the projected shortfall, the government could index benefits to prices instead of wages –which historically have exceeded inflation-, adjust the Cost of Living Adjustment (COLA) or increase the retirement age. Another choice would be the adoption of private accounts for individual workers.

However, opponents to this privatization approach believe that it does not solve Social Security's long-term burden mainly because this is a pay-go system in which payroll taxes are used to pay current benefits, therefore, deviating payroll taxes from the system will only increase the problem. Increasing the retirement age will boost fiscal revenues as people work and pay taxes longer before they receive Social Security benefits. In addition, workers receive full benefits later in life, which reduces pensions cost. Another measure is to index the pensionable age to life expectancy.

Healthcare reform: currently debated in Congress, it is aimed at solving two main problems: coverage and costs. It is widely accepted that containing healthcare costs is the single most important step that can be taken in order to release pressures on the long-term fiscal balance. While proposals deal with coverage, quality, and other issues, from a fiscal perspective an effective healthcare reform has to lower the health cost per beneficiary and be deficit-neutral, which means that every additional dollar spent should be compensated by an increase in taxes or a reduction in spending in other areas.

Pay-go rules: this would guarantee that tax cuts and spending increases be offset by corresponding tax increases or spending cuts. Recently the House approved a PAYGO measure for taxes and mandatory spending, however, the measure does not cap discretionary spending such as the stimulus package.

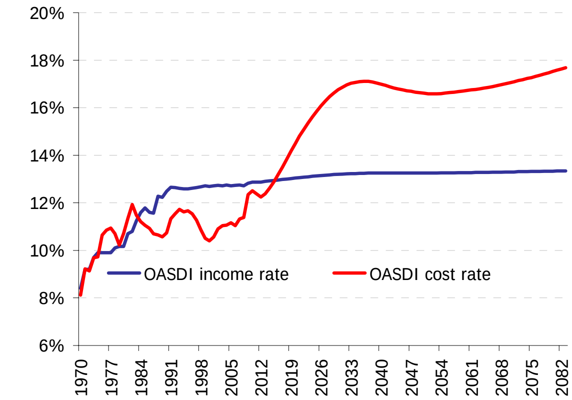
Summary

Long-term pressures on the fiscal budget are not new; nonetheless, effective policy response has been delayed. In the absence of significant changes, the public debt will move towards an unsustainable path. Economic recovery *per se* will not assure a substantial and sustained improvement in the fiscal position. Moreover, demographic trends and higher healthcare costs will cause an exponential increase in public debt over the long-run.

Reducing the debt burden in the long-run implies taking politically costly actions in the short-run. However, the current economic crisis could offer a solution to this dilemma and open the door for deep and far-reaching reforms. As "crisis hypothesis" states, times need to get very bad to induce changes, and if reforms are not passed this time, the situation was not bad enough.[5]

5 Easterly, William and Drazen, Allan. Do Crises Induce Reform? Simple Empirical Tests of Conventional Wisdom. Economics and Politics, Vol. 13, No. 2, pp. 129-158, July 2001.

Social Security: Income and Cost Rates
(Percentage of taxable payroll)



Source: Social Security Administration

Appendix C of the 1983 Greenspan Commission on Social Security Reform

FINDINGS AND RECOMMENDATIONS

"The National Commission has agreed that there is a financing problem for the OASDI program for both the short run, 1983-89 (as measured using pessimistic economic assumptions) and the long range, 1983-2056 (as measured by an intermediate cost estimate) and that action should be taken to strengthen the financial status of the program.(1) The National Commission recognized that, under the intermediate cost estimate, the financial status of the OASDI program in the 1990s and early 2000s will be favorable (i.e., income will significantly exceed outgo) -- see Table 7A in Appendix K. The National Commission also recognized that, under the intermediate cost estimate, the financial status of the HI program becomes increasingly unfavorable from 1990 until the end of the period for which the estimates are made…"

CATO Institute on Healthcare Reform

"The need for changes could not be clearer. Health care costs are growing unsustainably. And, while America leads the world in medical innovations and responsiveness to patients, there are large deficiencies in many areas, including the frequency of medical errors, and patients losing their health insurance at the very moment they need it most. Further, much of the U.S. health care sector lacks basic advances that have been incorporated by other parts of America's economy, electronic recordkeeping in particular. "