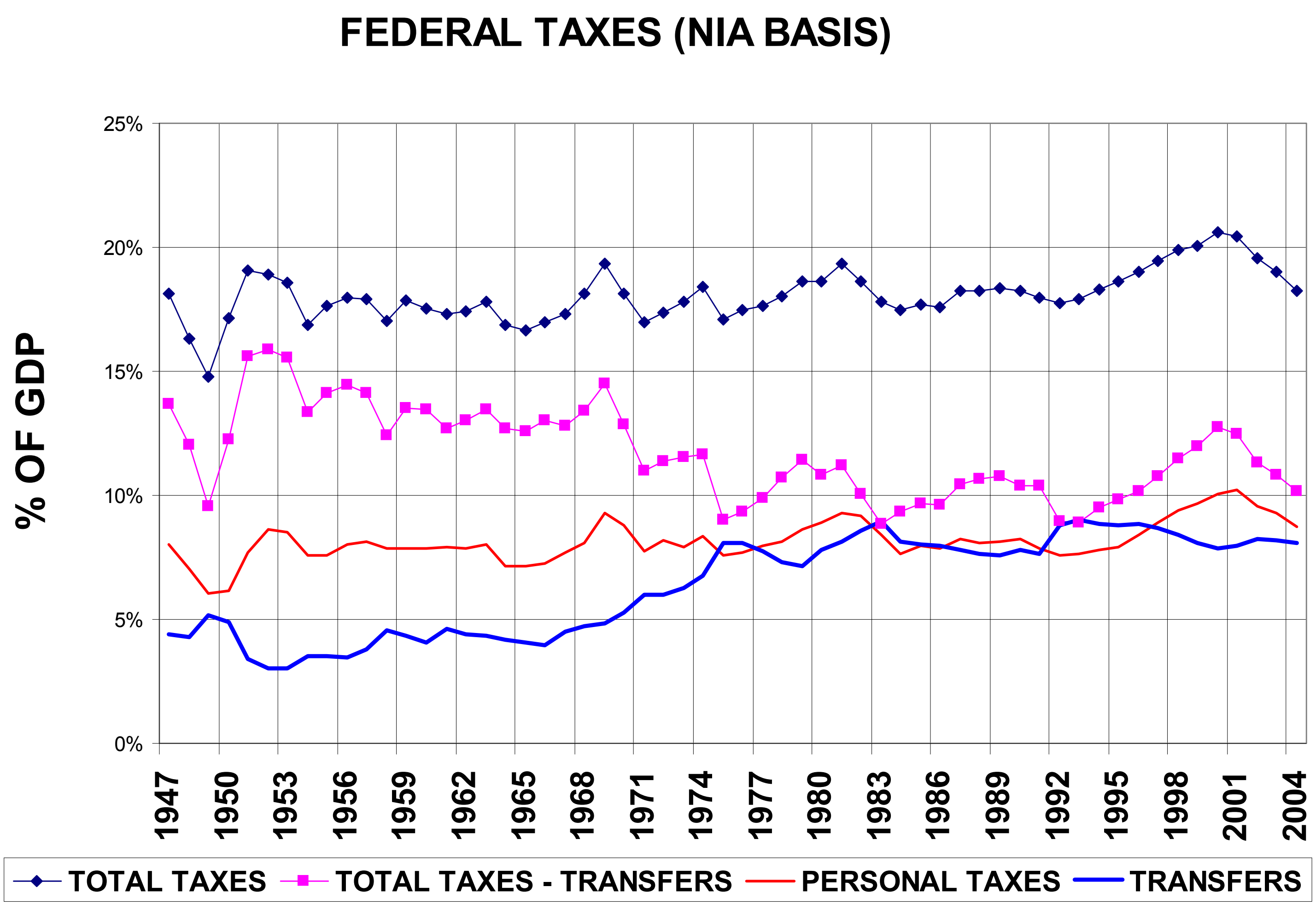
U.S. Fiscal Policy in the 1990s

Lecture 18

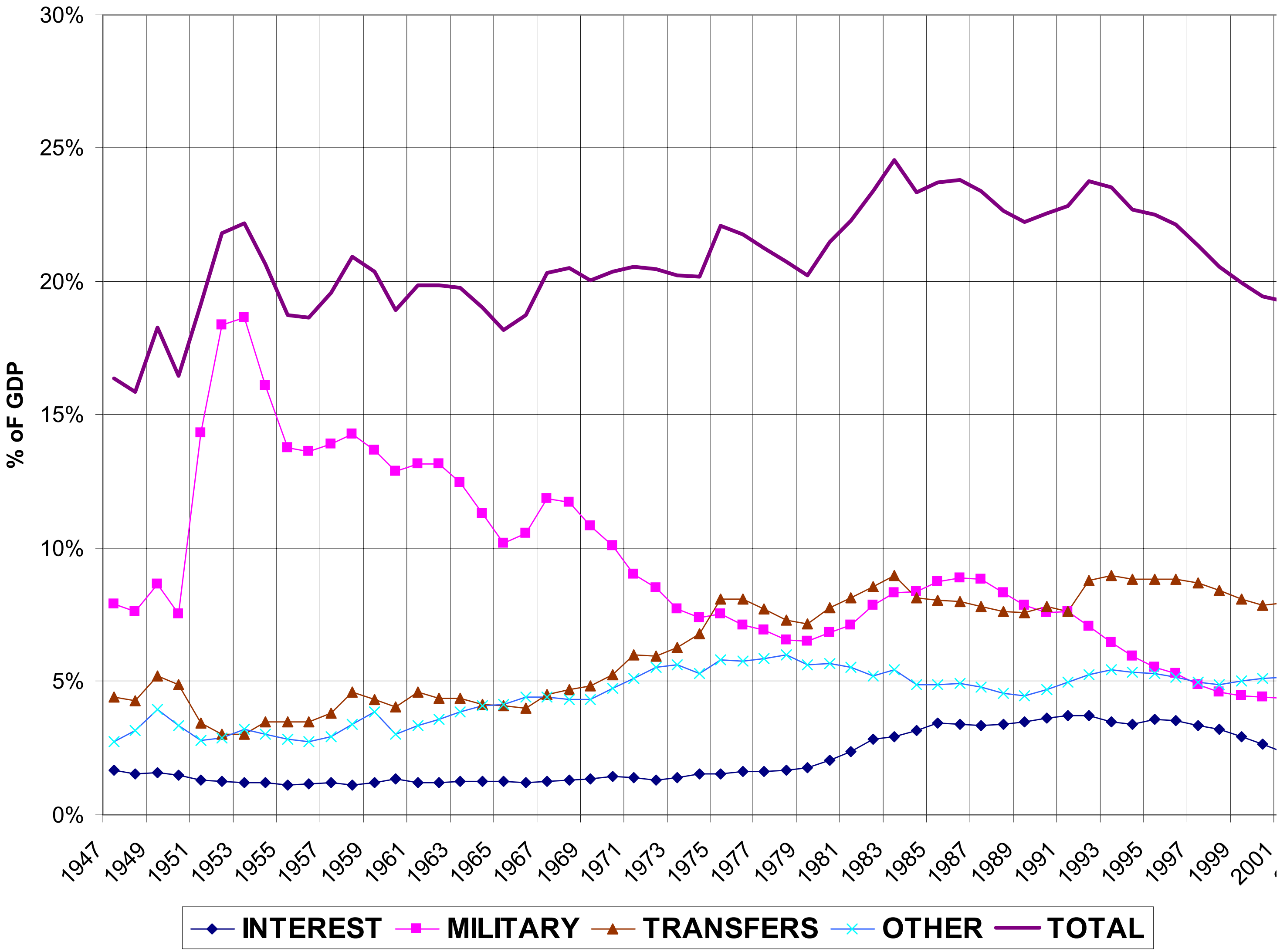
FEDERAL BUDGET HISTORY

- Taxes have trended up largely to pay for greater entitlements (transfers)
- Taxes less transfers were reduced in the 1970s to prepare for baby-boom retirement
- The Carter (77-80) and Clinton (92-00) terms saw increased taxes to reduce inherited deficits



FEDERAL BUDGET HISTORY

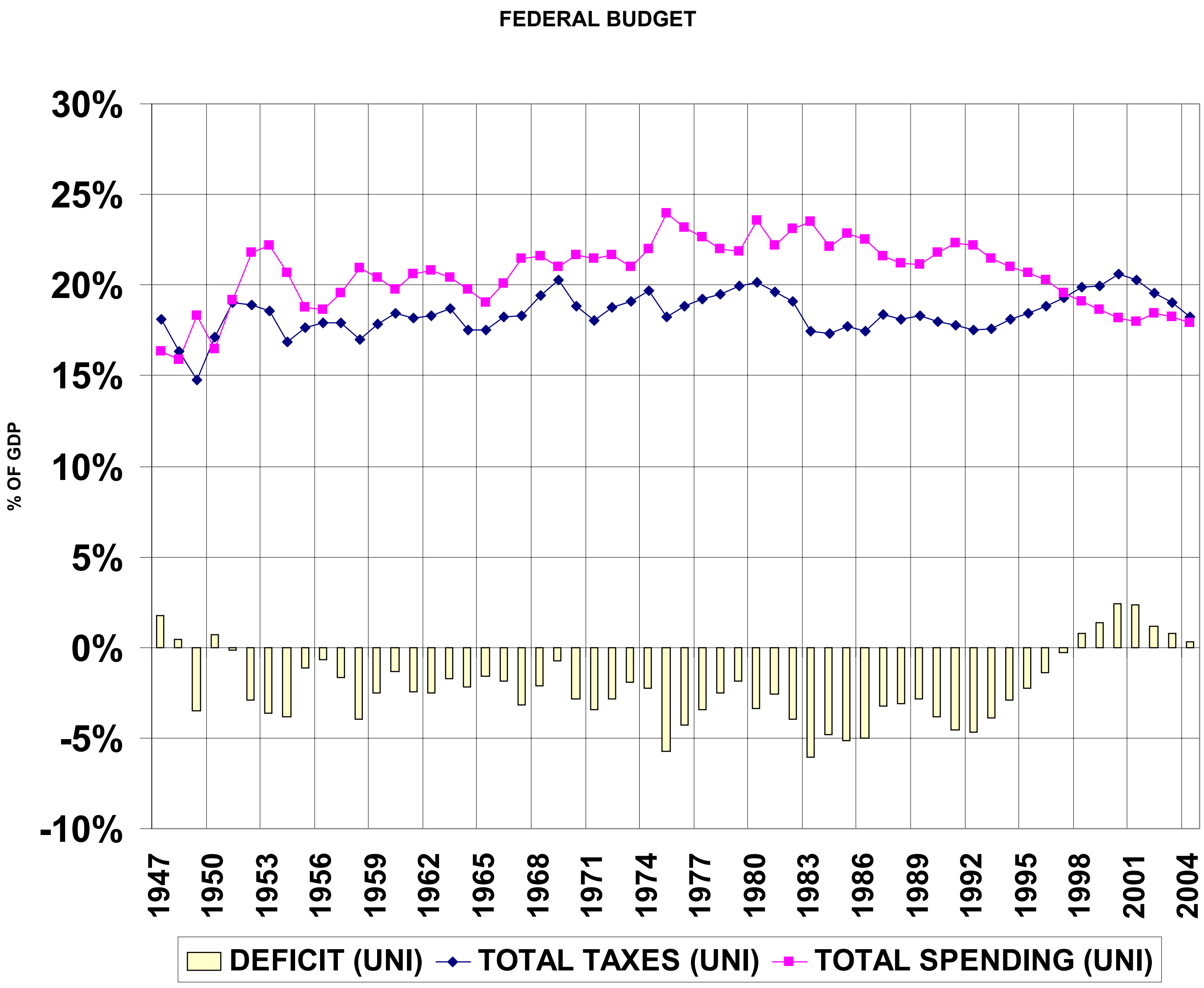
FEDERAL SPENDING (NIA BASIS)



- •Military spending is now below pre-WWII %'s
- •Transfers have surged
- •Other categories rose in the 1960s

- •Under Reagan, spending rose to a peak of 25%
- •Military spending surged
- •The huge deficits raised interest payments
- •Other categories were cut

FEDERAL BUDGET HISTORY



- •Note the similar efforts to close the deficit under Carter and under Clinton, by raising taxes and cutting spending
- •Note how unusual a surplus is
- •The Federal budget tended to absorb 20% of GDP, with a clear upward trend

FEDERAL BUDGET HISTORY

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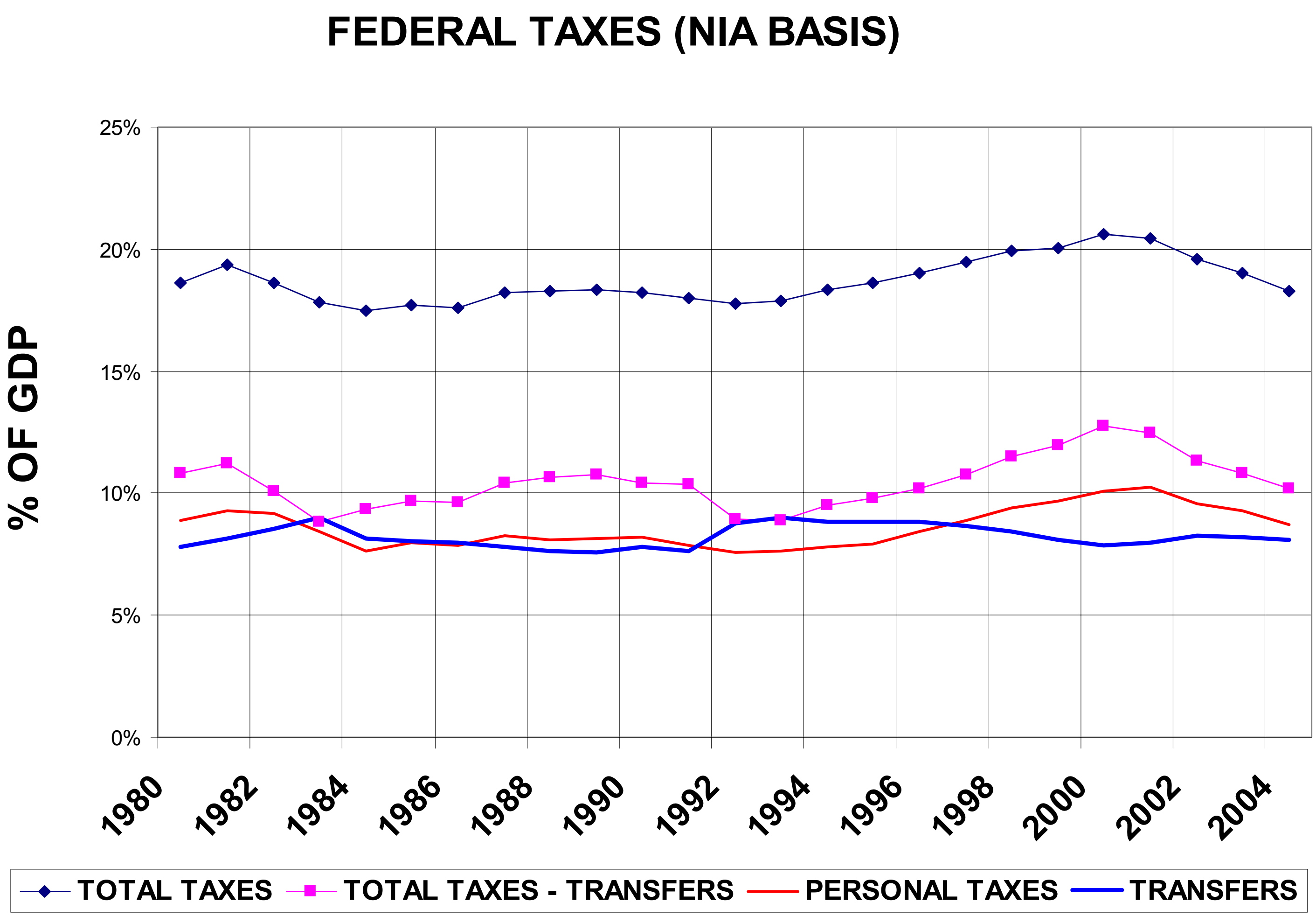
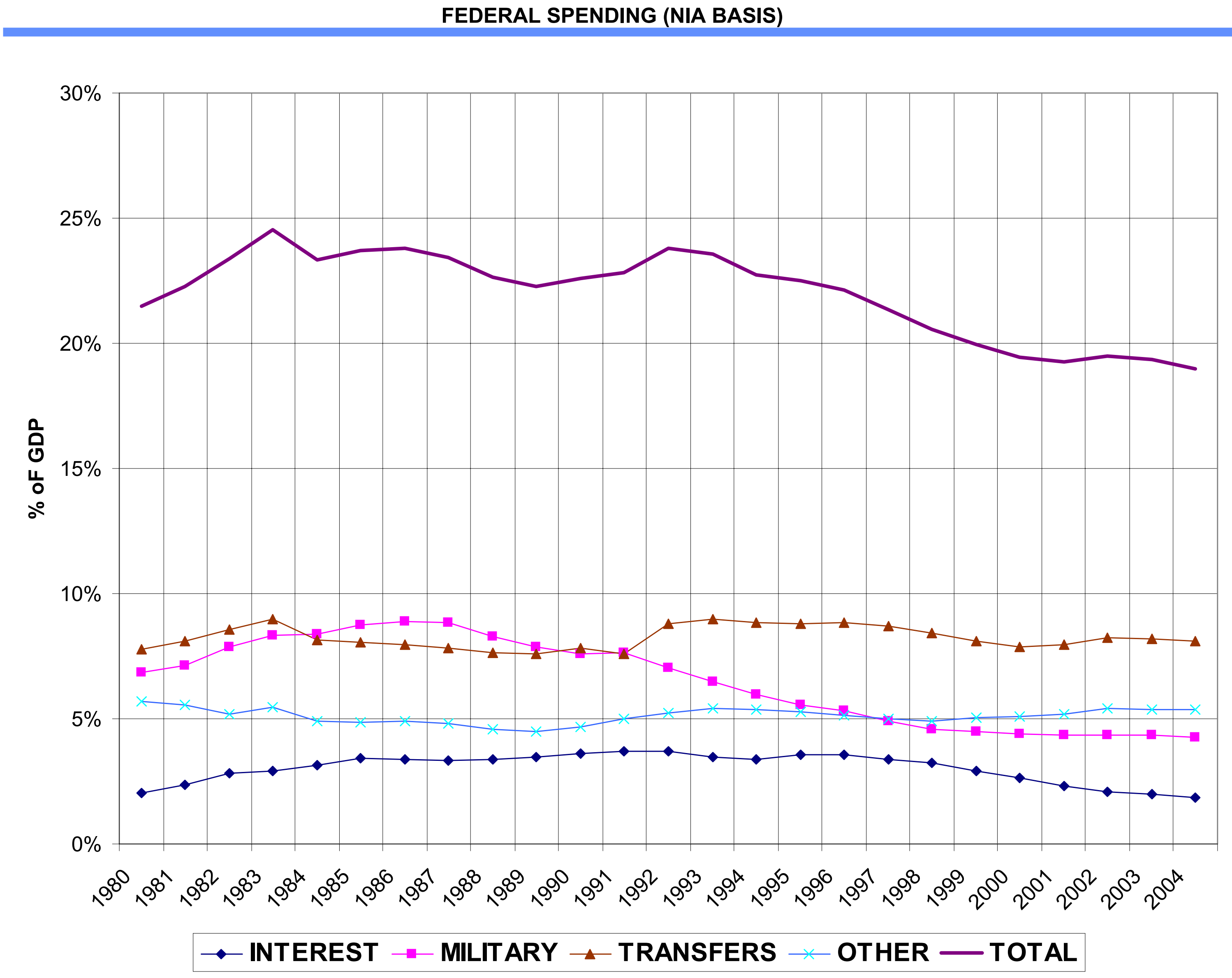


FEDERAL BUDGET HISTORY



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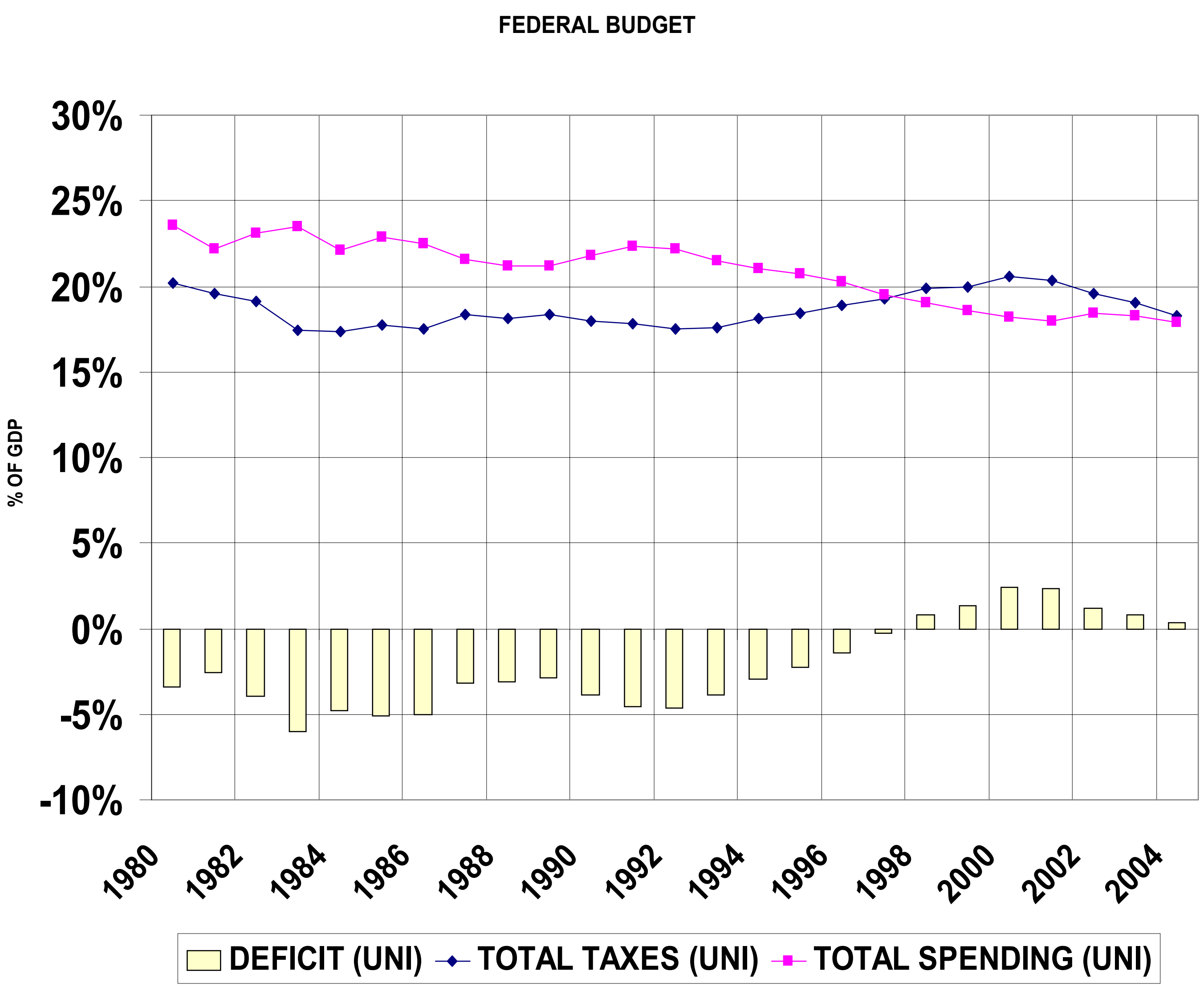

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U.S. Fiscal Policy in the 1990s

- After a decade of extreme deficit spending, all three presidential candidates in 1992 promised to move toward a balanced budget in five years
  - Ross Perot promised a blend of tax increases and budget cuts
  - George Bush offered spending cuts but, under pressure from the Republican Party, promised new tax cuts
  - Bill Clinton promised higher taxes and spending cuts in existing programs, but added new spending on education and infrastructure, thereby retaining a deficit
- Clinton, the victor, proposed his campaign program in 1993 but Congress rejected it, favoring more aggressive action to balance the budget
  - The Democrats controlled Congress, but yielded to public opinion to reject delays in balancing the budget beyond a 5-year plan
- In the campaign for the 1994 Congress, the Republicans offered a strict plan they called “The Contract for America”
  - This promised budget balance, welfare reform, and select new tax incentives
  - They won control of the House and Senate and implemented the basics of their fiscal strategy

U.S. Fiscal Policy in the 1990s

- During this debate, research groups such as DRI analyzed the impacts
  - The exhibits that follow were produced in late 1994 and early 1995
  - They reveal the expected outcomes, presenting the mainstream macro-economics position on this debate
  - The exceptional boom of the late 1990s met and often exceeded these expectations:
  - The actual 1995-1998 data and current forecasts through 2002 are added to a few of the slides to precisely compare results with expectations

Prospects for the Economy through 2002

Slower population growth means slower labor force growth.

Productivity growth will continue to be hurt by inadequate private investment.

But,

Tax changes could boost labor force participation by second earners and retirees.

Welfare reformed to workfare could add over a million productive employees.

Gradual achievement of federal budget balance would greatly bolster private investment.

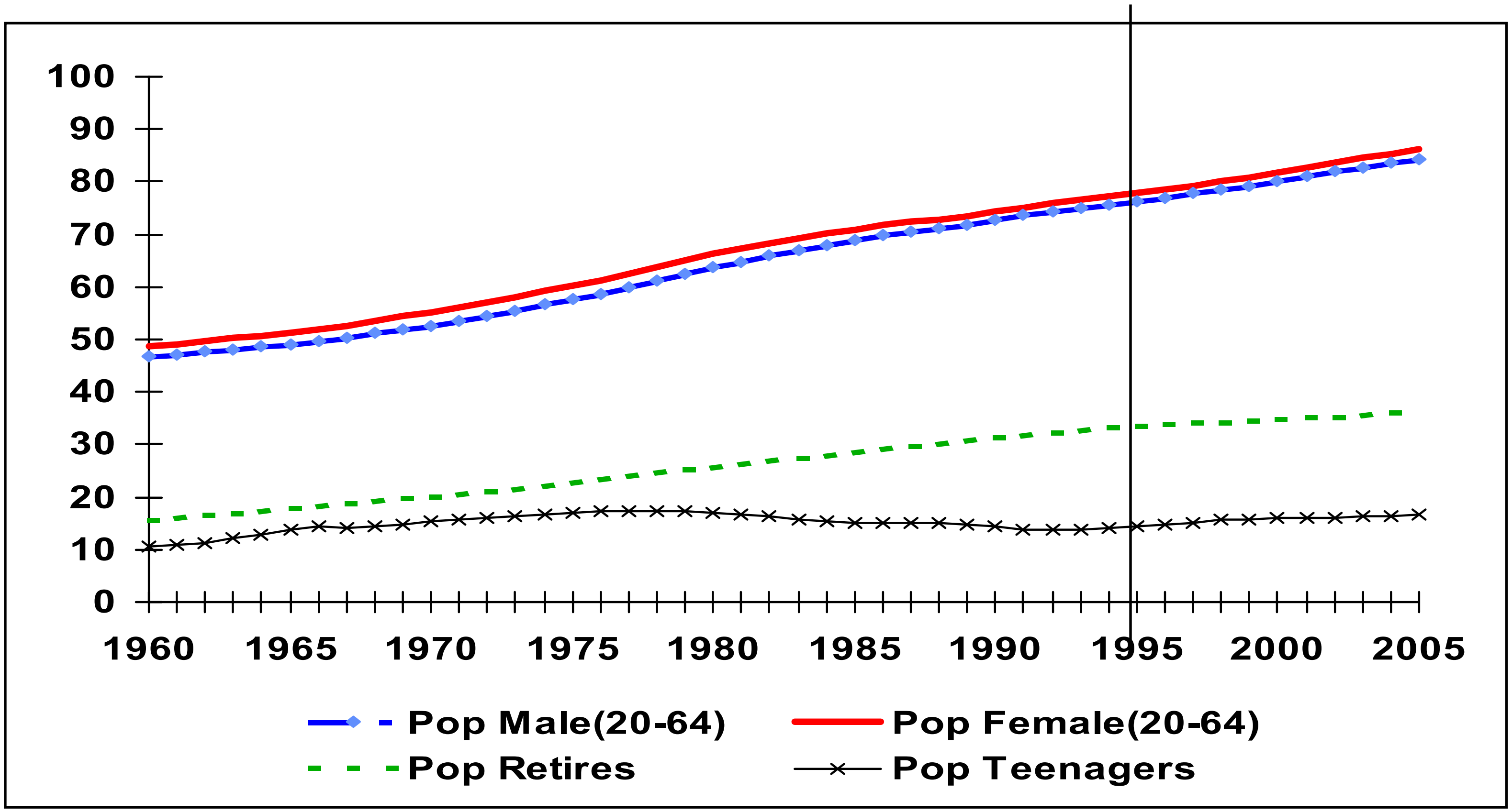
Capital gains tax cuts would also boost national growth.

Summary of the Forecast Made in 1994, and the Results as of 1999

	'82-'94	'95-'02Fore	'95-'98 Actual
Unemployment Rate	6.9	5.8	5.1
Real GDP Growth (annual)	2.9	2.4	3.4
Housing Starts (million)	1.4	1.3	1.5
Consumer Price Inflation	3.8	3.4	2.4
Productivity Growth	1.3	1.4	1.6
Prime Rate	9.4	7.9	8.5

Adult Population Growth Has Fallen to Approximately 1% Per Year

population by age group, millions



Population Growth Rates by Age and Sex

Average Growth Rates

	60's	70's	80's	90-94	95-99	2000-05
Males (20 to 64)	1.1	1.9	1.4	1.0	0.9	1.0
Female (20 to 64)	1.2	1.8	1.2	0.9	1.0	1.0
Retirees (above 65)	2.6	2.4	2.0	1.6	0.8	0.9
Teenagers (16 to 19)	3.6	1.5	-1.5	-1.1	2.4	0.9
Total	1.6	1.9	1.2	0.9	1.0	1.0

The Labor Force Will Also Grow Only Slightly Faster Than 1% Per Year

Average Growth Rates

Teenage and Female Components Will Exhibit the Fastest Growth

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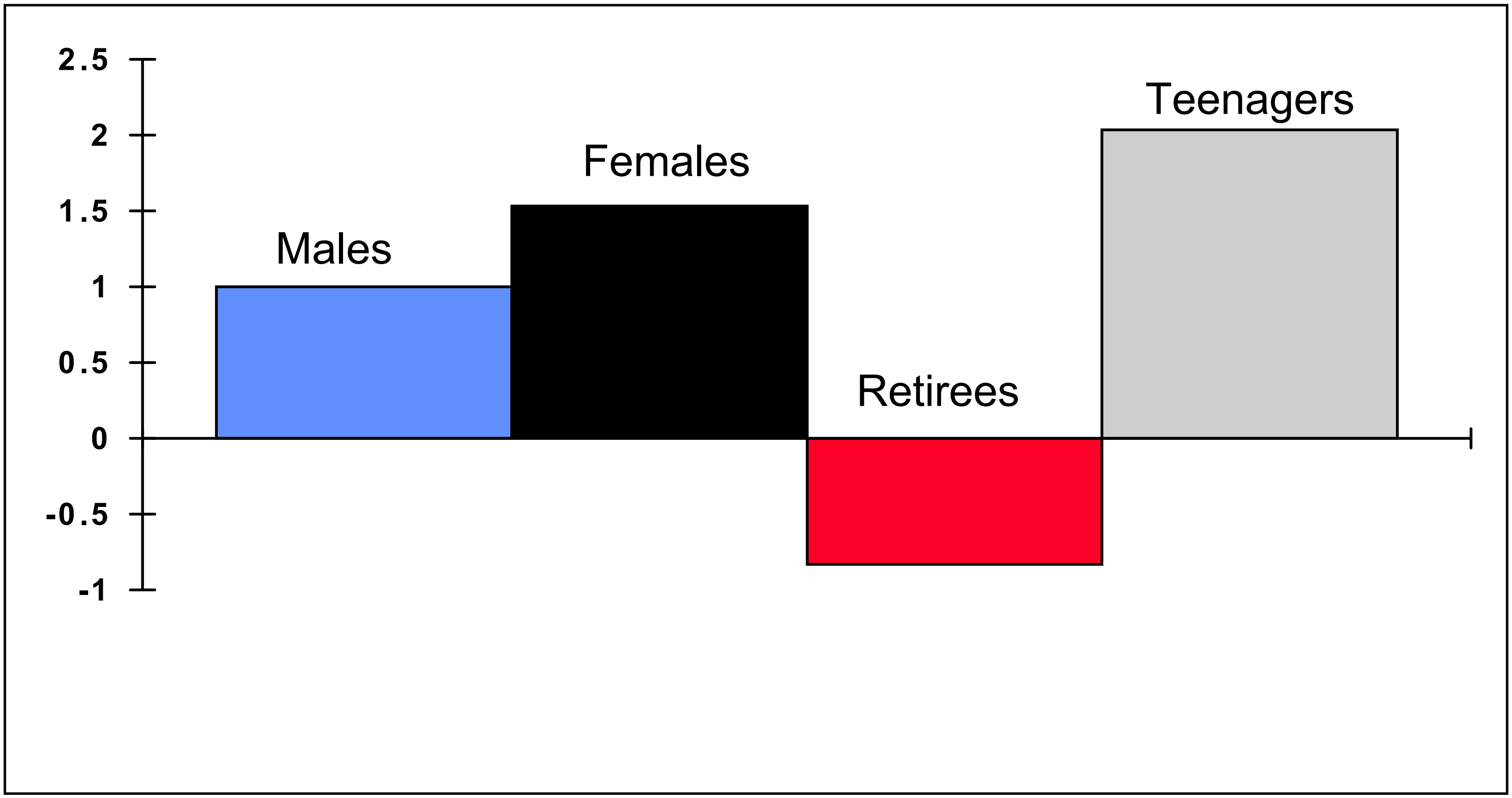
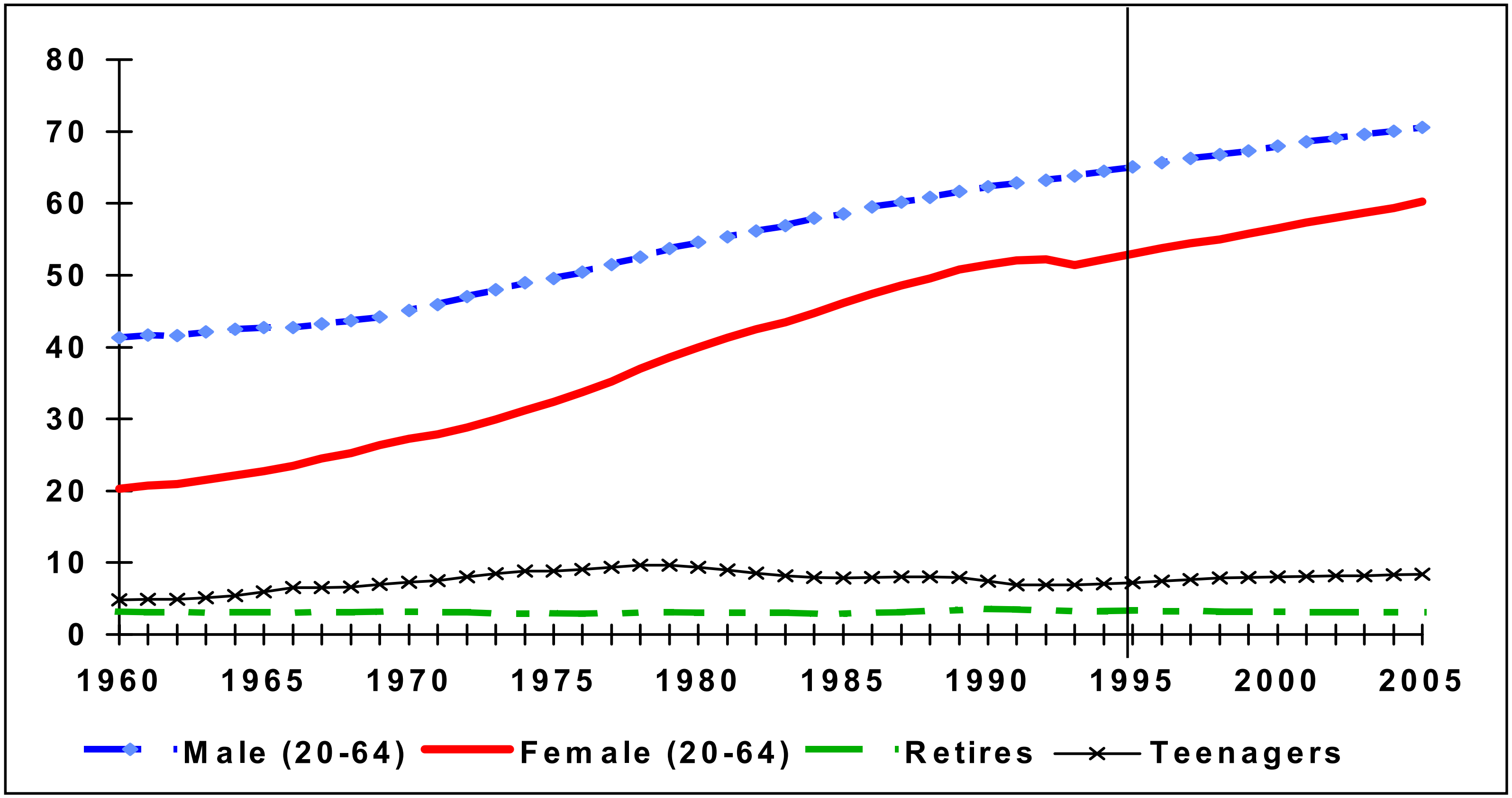
(average labor force growth rates, 1995-2002)



The Labor Force Is Rising at a Similar Pace Because the Big Gain From Women Becoming New Earners Appears Past

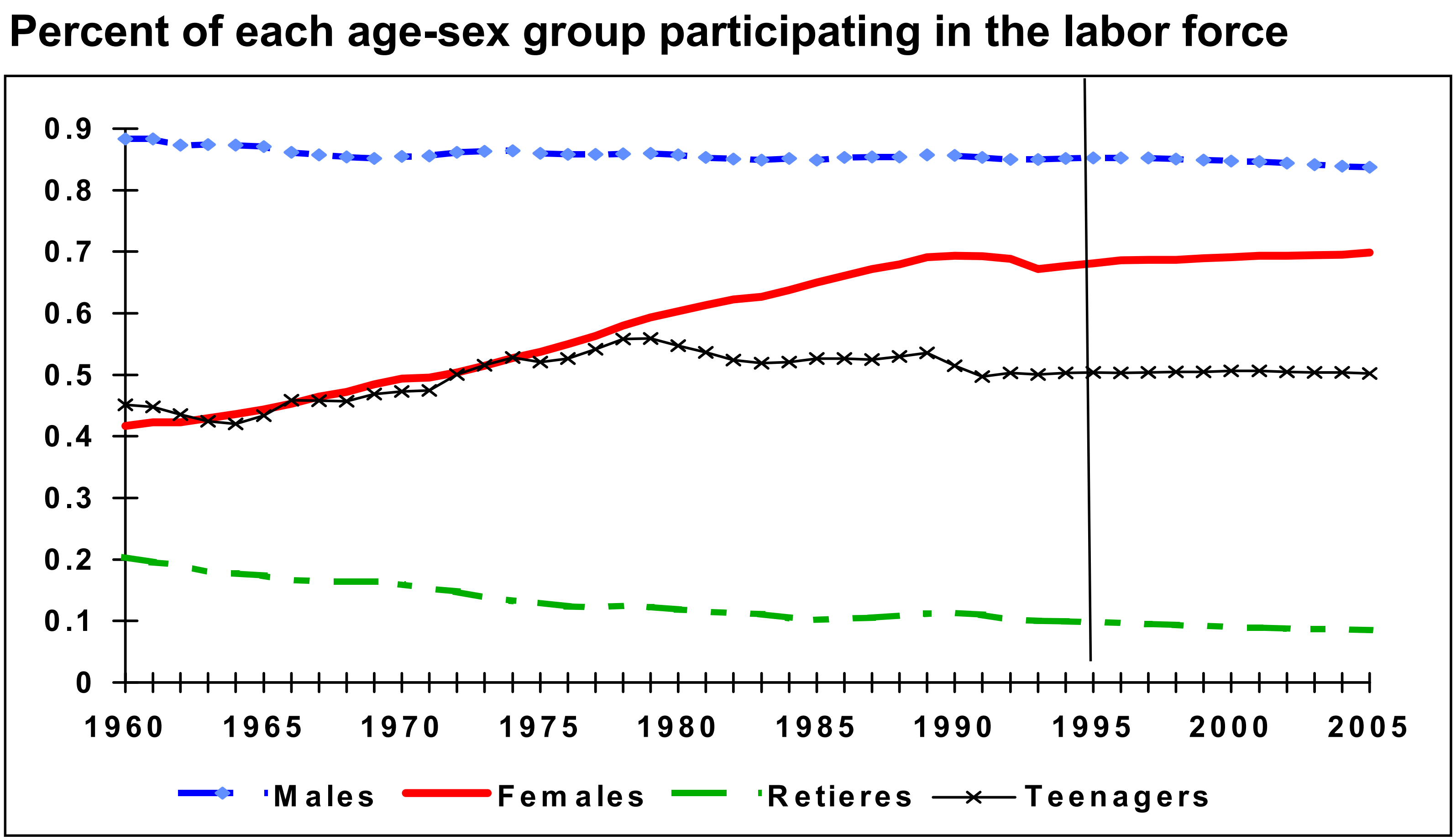
Labor Force by Age-Sex Group, Millions



Participation Rates...

.. for Prime-Age Women Rose to Nearly Match Those of Men

..while retirees are less inclined to work.



The Recent Gains in Productivity Are Not At All Exceptional: They Reflect Normal Cyclical Boosts and Responses to Capital Formation

The Future Is Likely to

Resemble the Recent Past

Unless

National Saving and Investment Improve and More People Want to Work

Key Contributors to Long-Term Growth

Average Growth Rates

	1982-1994	1995-2002
Labor Force	1.5	1.3
Capital Stock	2.8	3.1
R&D Expenditures	4.3	3.7
Potential GDP	2.35	2.44
Productivity	1.13	1.44

Productivity Growth is Always Best in the Opening Years of a Recovery

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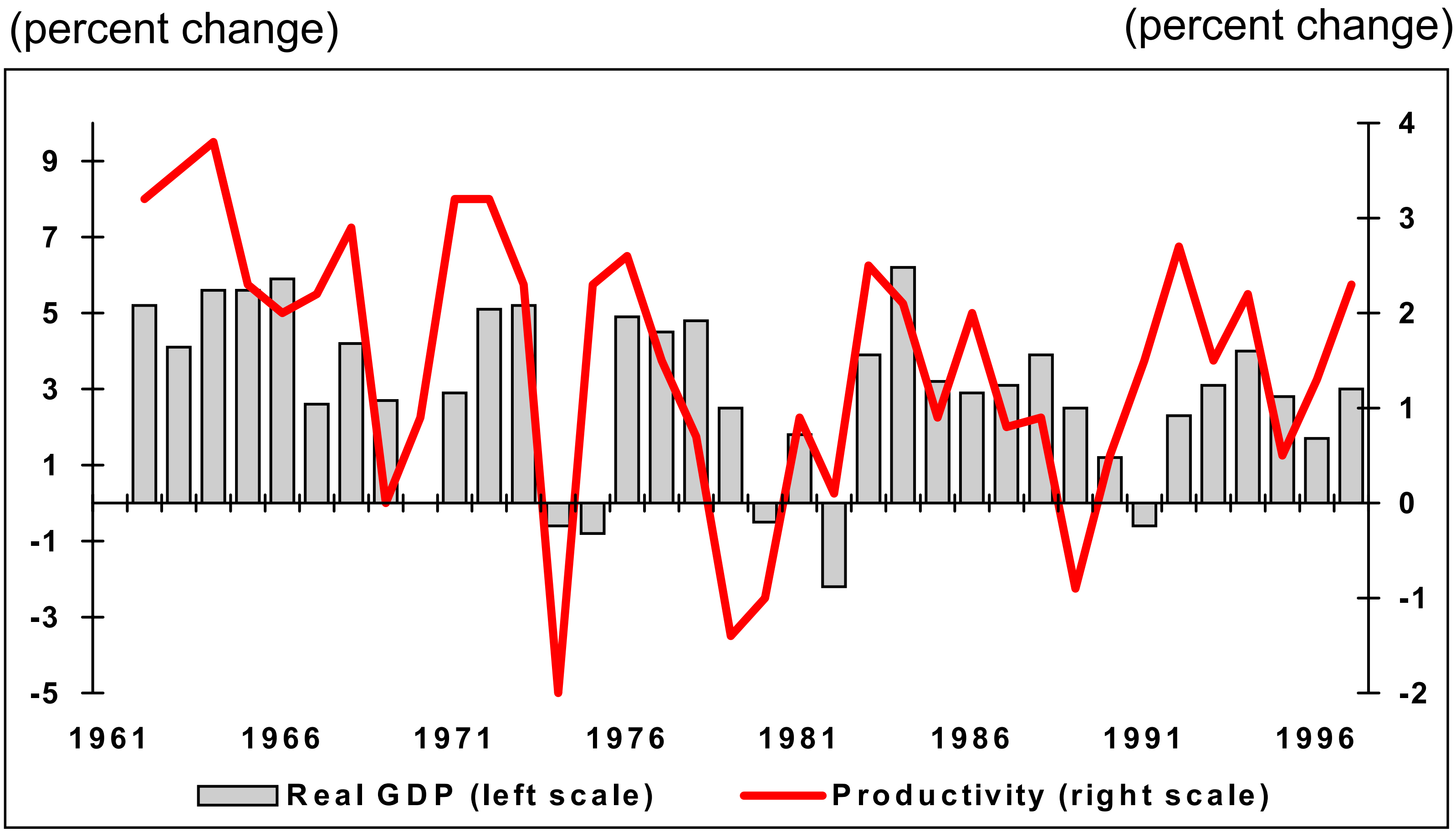
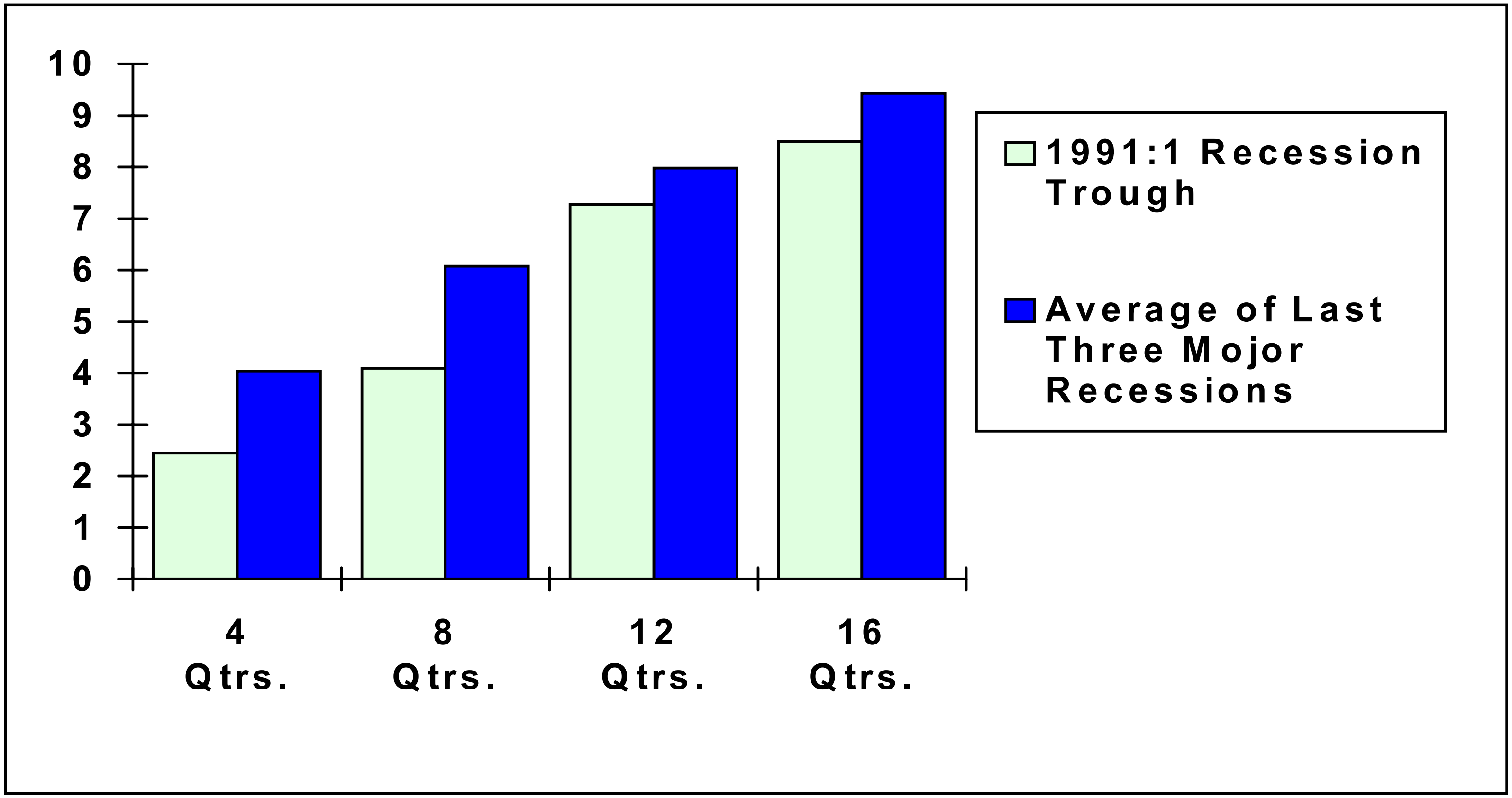


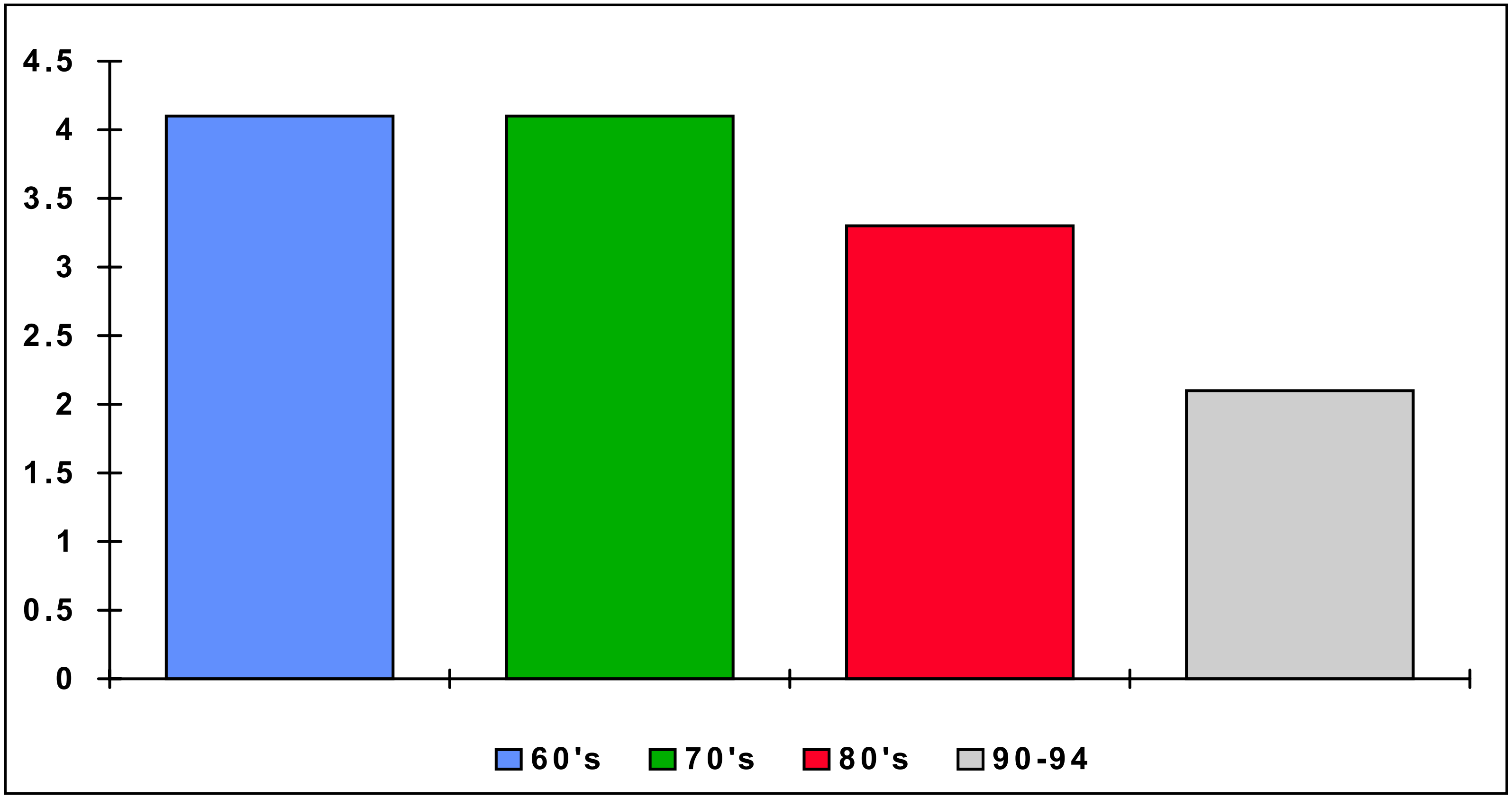
This Recovery Has Not Been Exceptional in Terms of Productivity Growth

Cumulative Productivity Growth During Recoveries
(Cumulative % Gain at Selected Intervals after a Recession Trough)



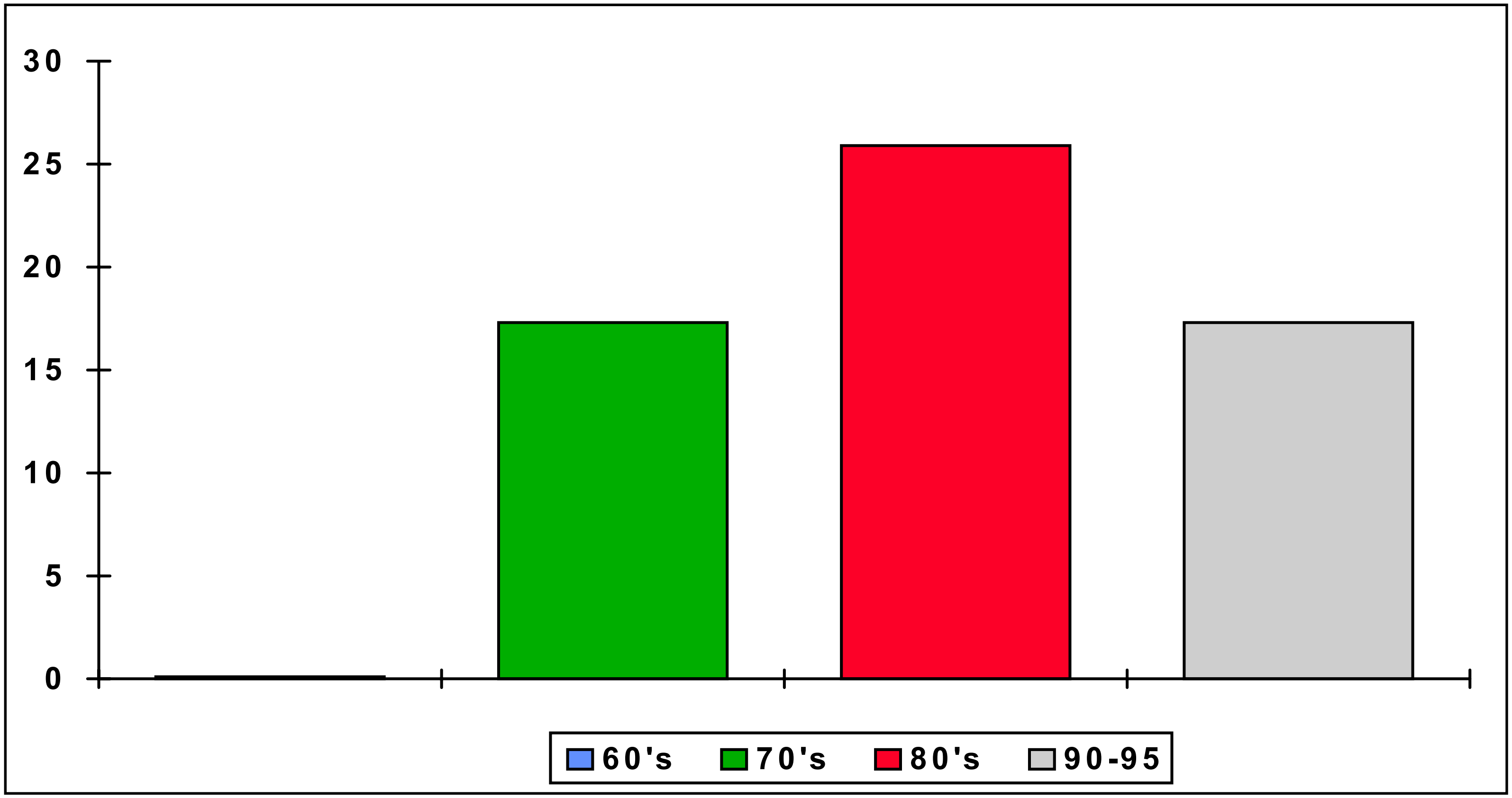
Total Business Capital Stock Growth Has Been Low By Postwar Standards...

Average Growth Rates of Total Nonresidential Capital Stock



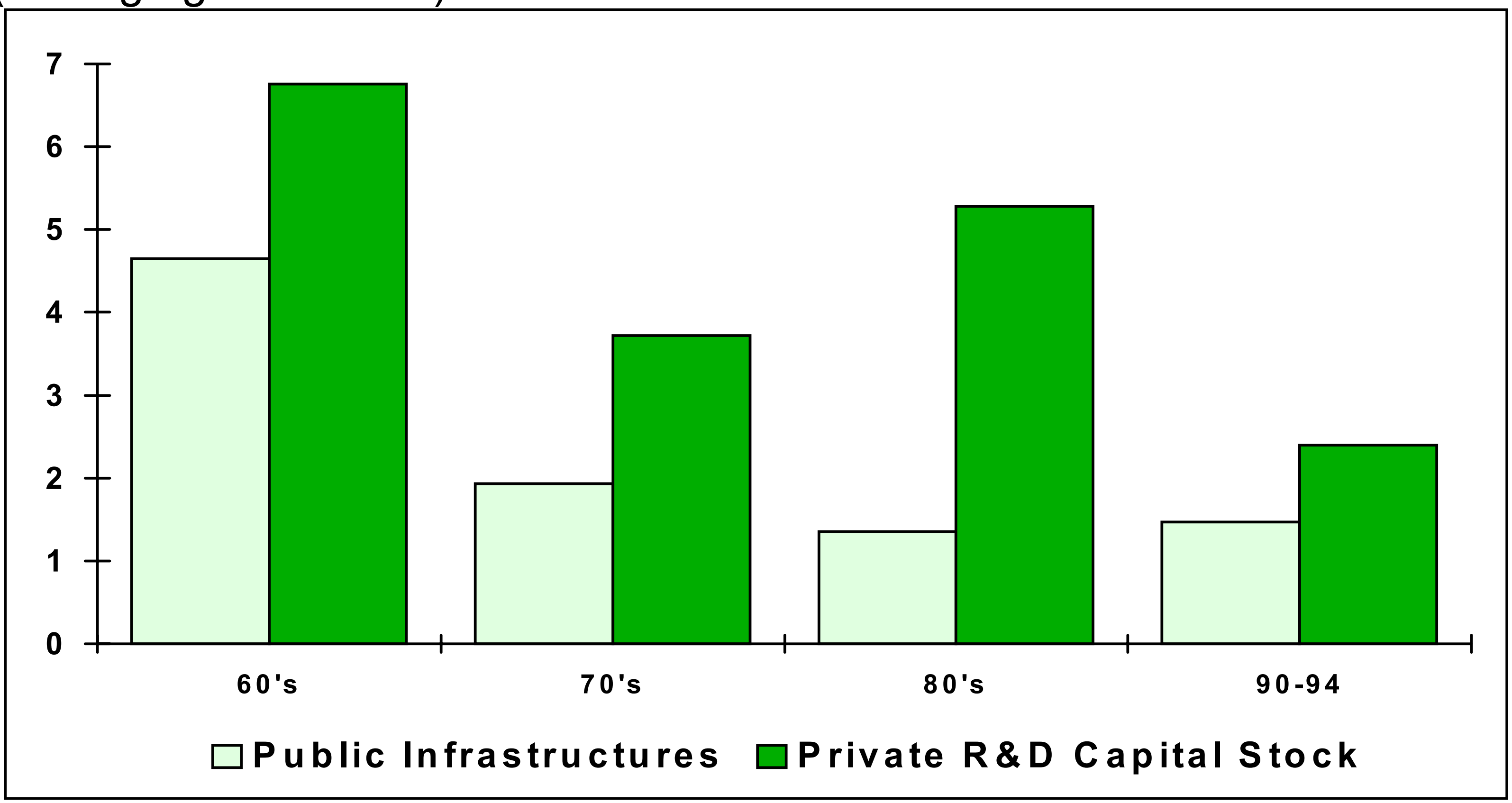
...In Spite of Exceptional Growth in Computer Equipment

Average Growth Rates of Capital Stock in Computers



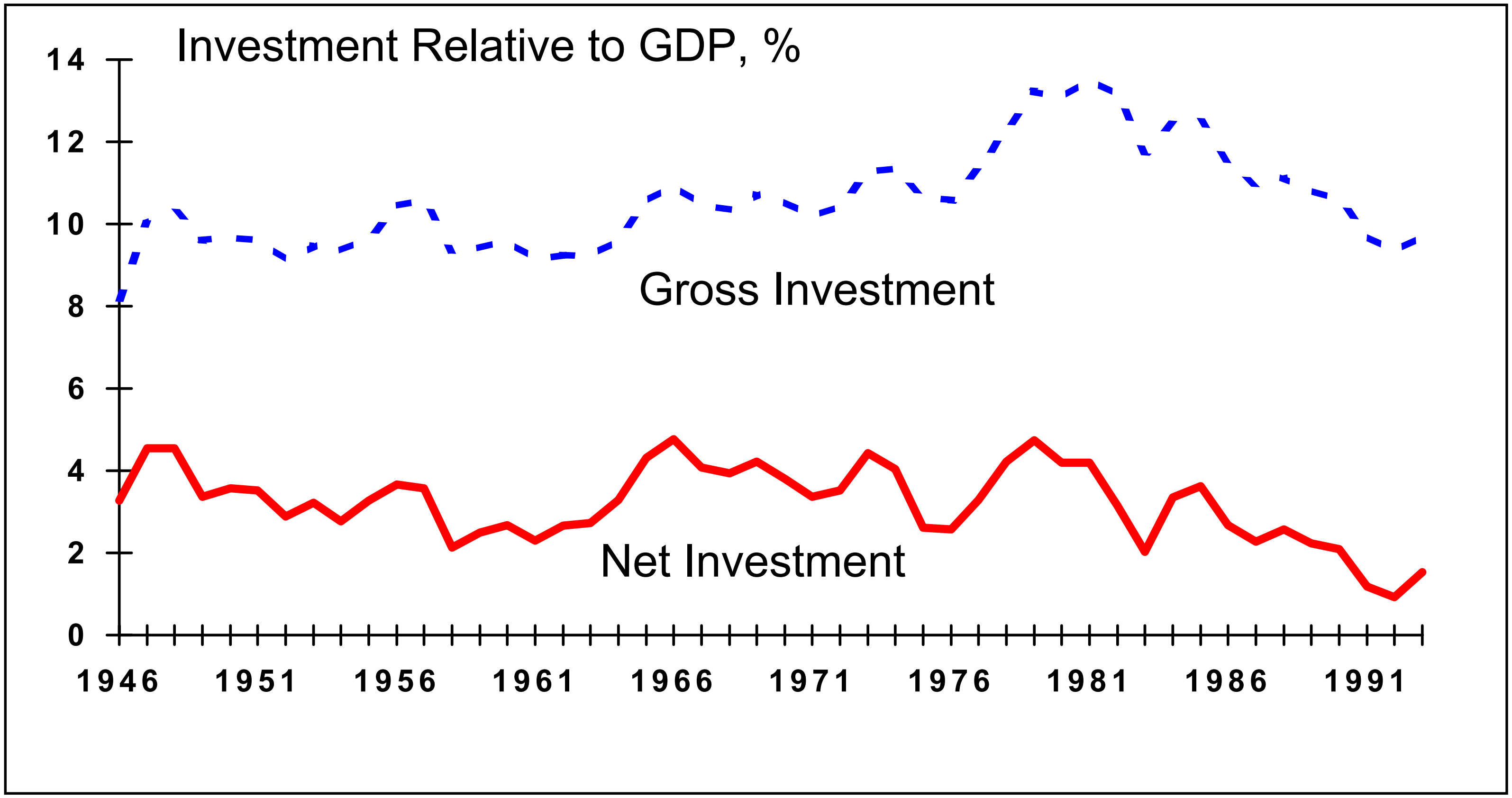
Growth in Other Forms of Capital Has Also been Weak in the 1990s

(average growth rates)



Net Investment is Exceptionally Low

Capital Spending as a % of GNP Has Been Declining and More of this Spending is on Short-Lived Equipment



WE CAN DO BETTER

Increase capital formation through diligent pursuit of budget balance and lower capital gain taxation .

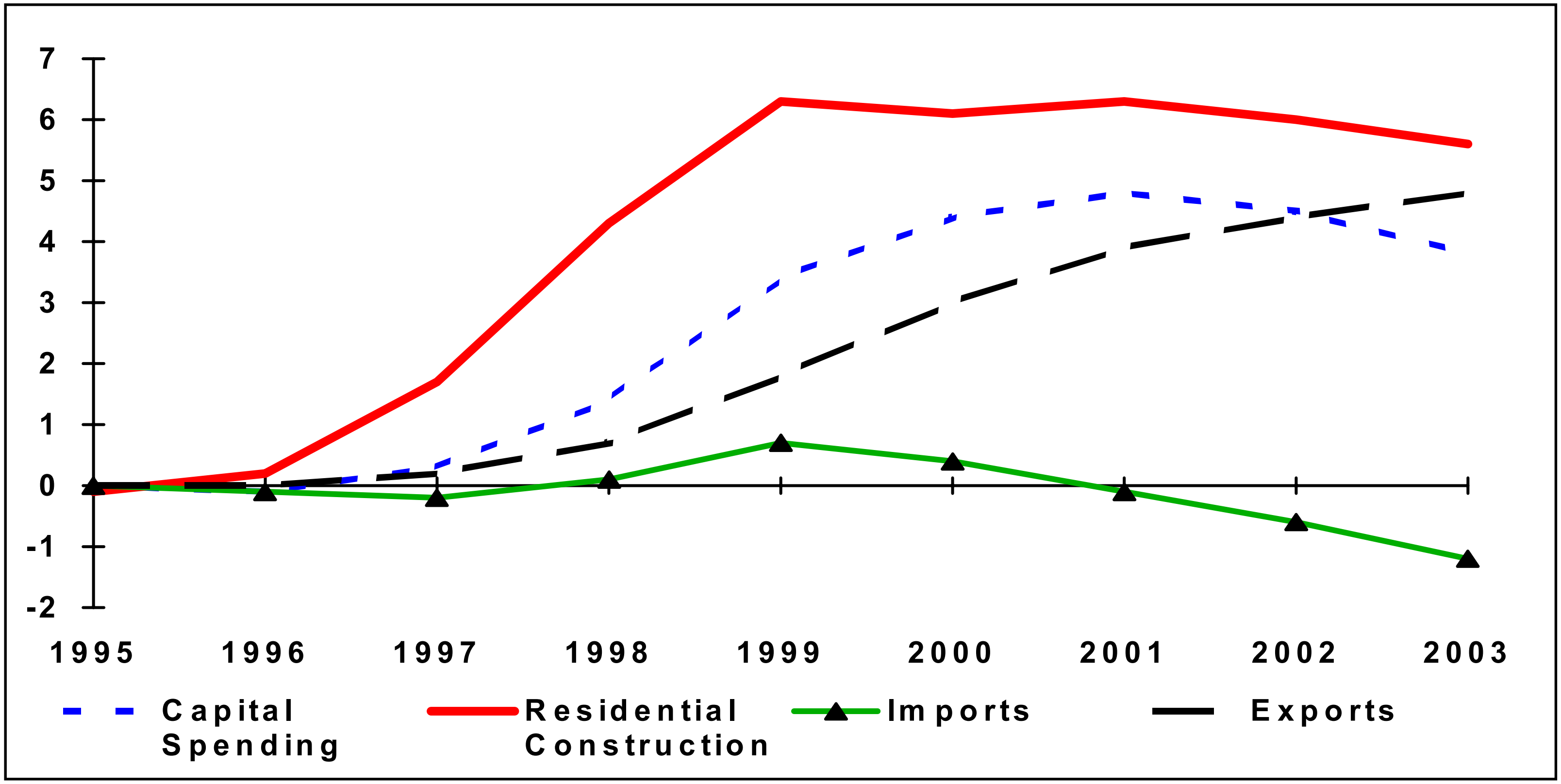
Motivate, not penalize, work effort through tax changes and workfare.

Support education reform and training.

Budget-Balancing Need Not Be Painful Nor Partisan:

Our Earlier Studies of a Concord Coalition Plan for Budget Balance by 2003 Demonstrated that as the Government Shrinks, Interest-Sensitive Sectors Will Rise

(Real Spending by sector, percent change relative to baseline)



To Update the Nonpartisan Concord Coalition Work in the Context of Current Policy Debates, DRI Has Created a Special Simulation :

Our Implementation of a Balanced Budget in 2002 Includes:

- **Elements in Common with the Republican *Contract*:**
  - **Personal Tax Cuts (Bad Economics; Good Politics?)**
  - **50% Capital Gains Tax Cut (16.5% top rate)**
  - **Welfare Reform**
  - **Greater Work Incentives (Marriage Penalty Reduced and Social Security Earnings Limit Raised)**
  - **Some Specified Spending Cuts and Transfers to States**
  - **But not the Extra-Generous Investment Incentives or Inflation Indexation of Gains**

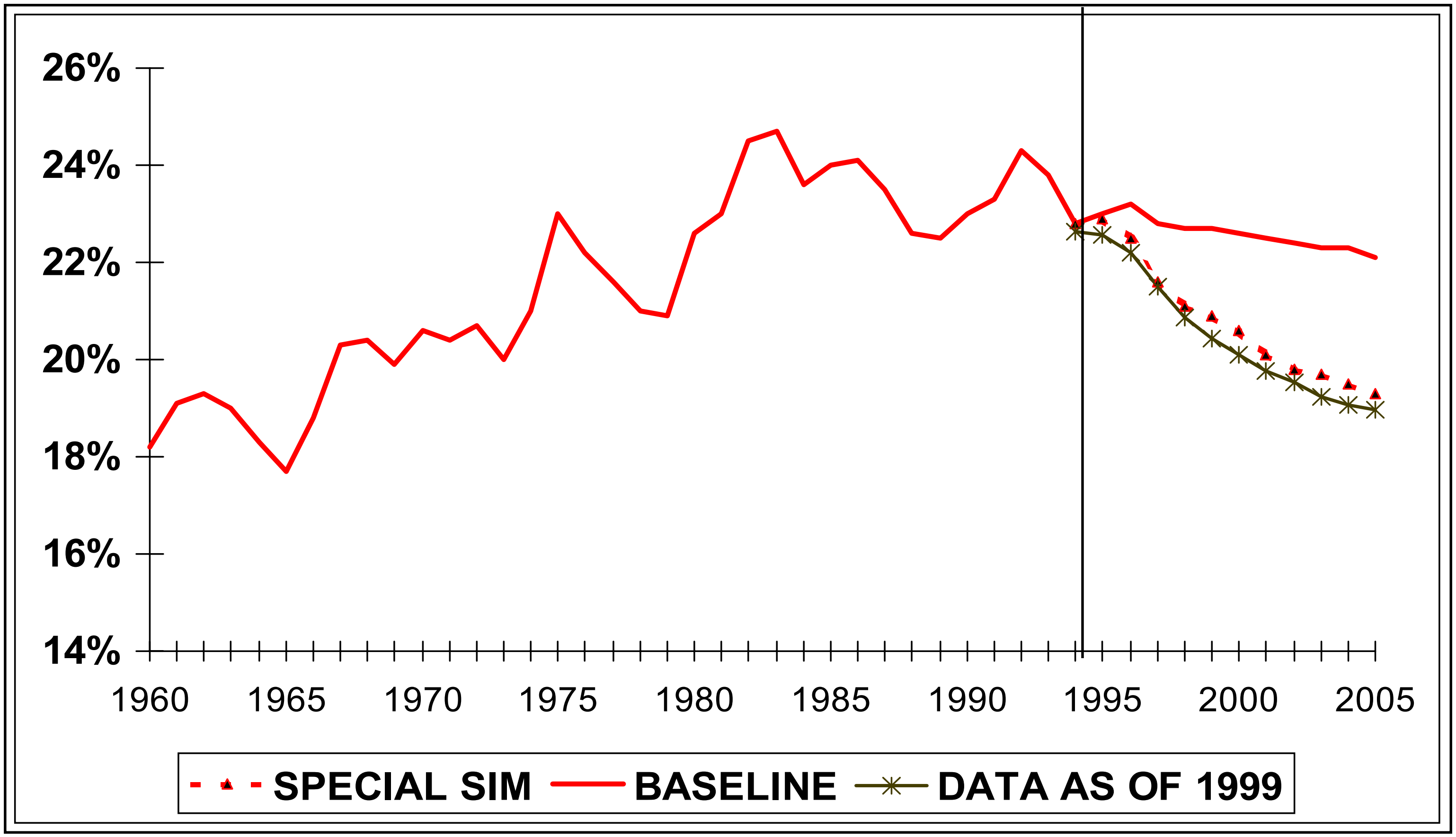
DRI Has Created a Special Simulation :

Our Implementation of a Balanced Budget in 2002 Includes:

- **From the Congressional Budget Office Options “Menu:**
  - **1 Percentage Point Reduction in Social Security Indexation**
  - **Taxation of Above-Average Employer-Paid Health Benefits**
  - **A Wide Range of Other, Reasonable but Tough Options**

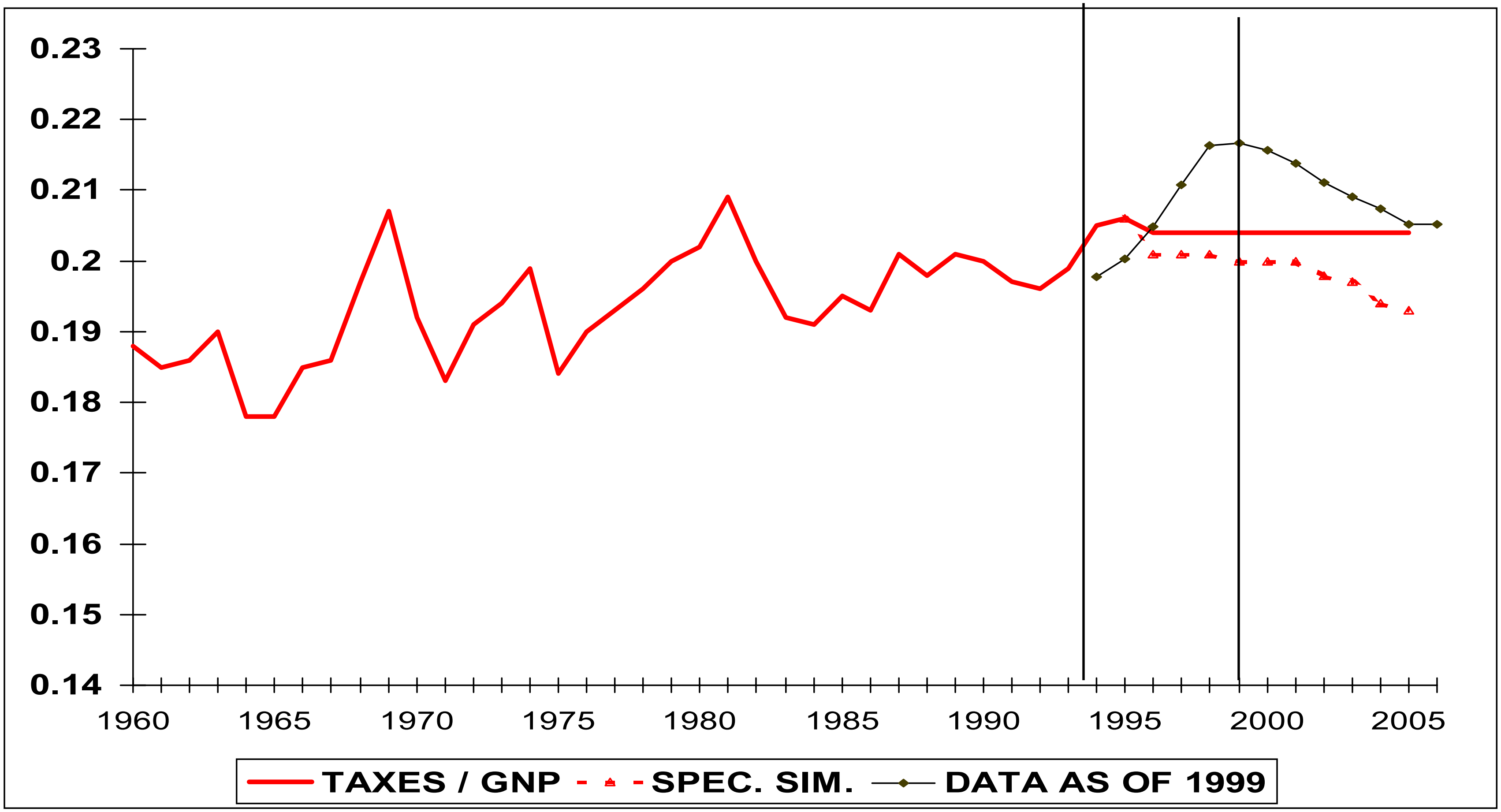
The Simulation Reflected the Call for A Much Smaller Economic Role for the Federal Government ; The Results to Date Slightly Exceed Expectations

Federal Spending, Including and Excluding Interest, Relative to GDP



Tax Cuts were planned, but the booming economy and stock market raised taxes relative to GDP!

Taxes Relative to Income

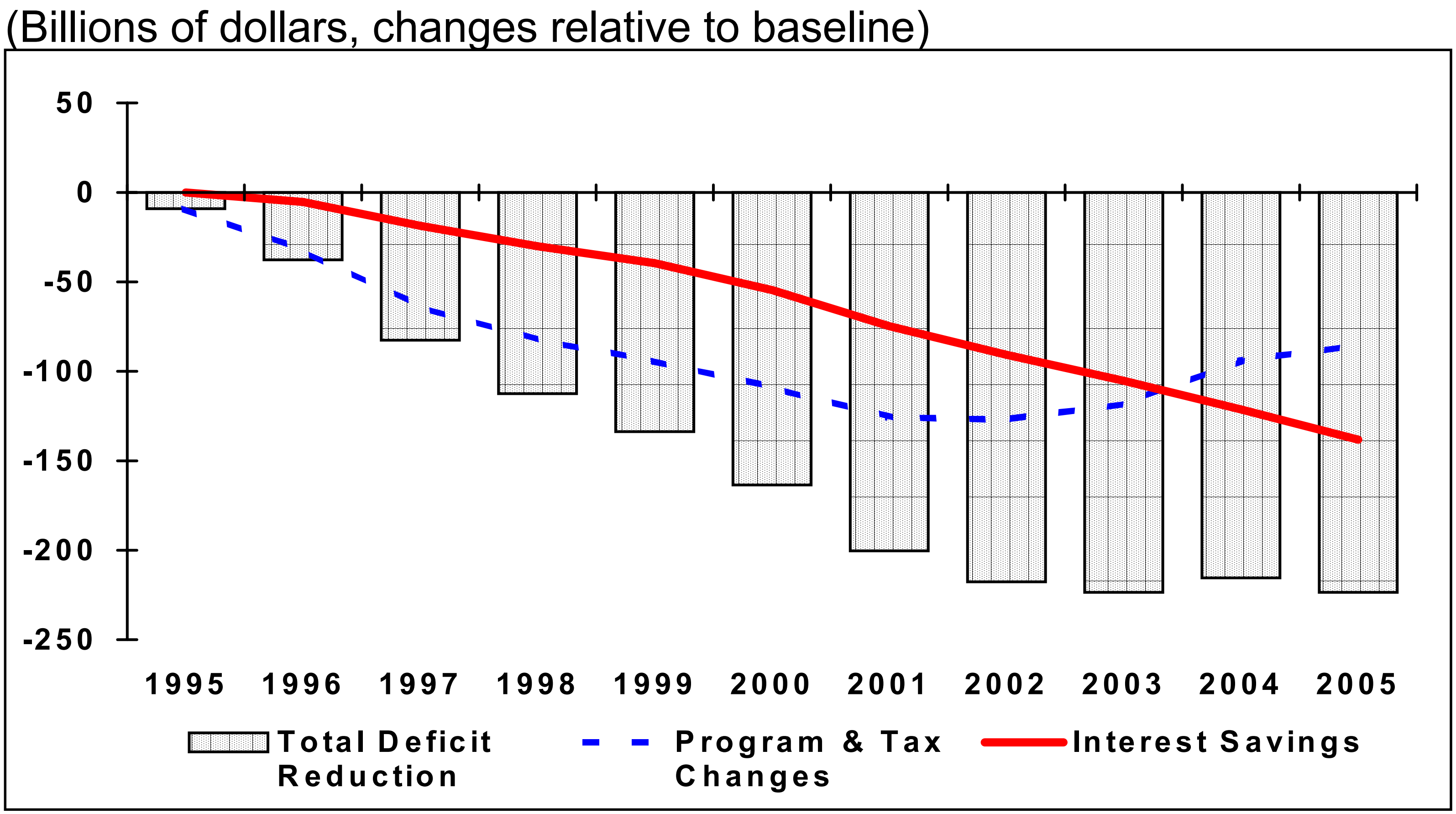


Fiscal Impacts, Including Responsible Economic Feedbacks

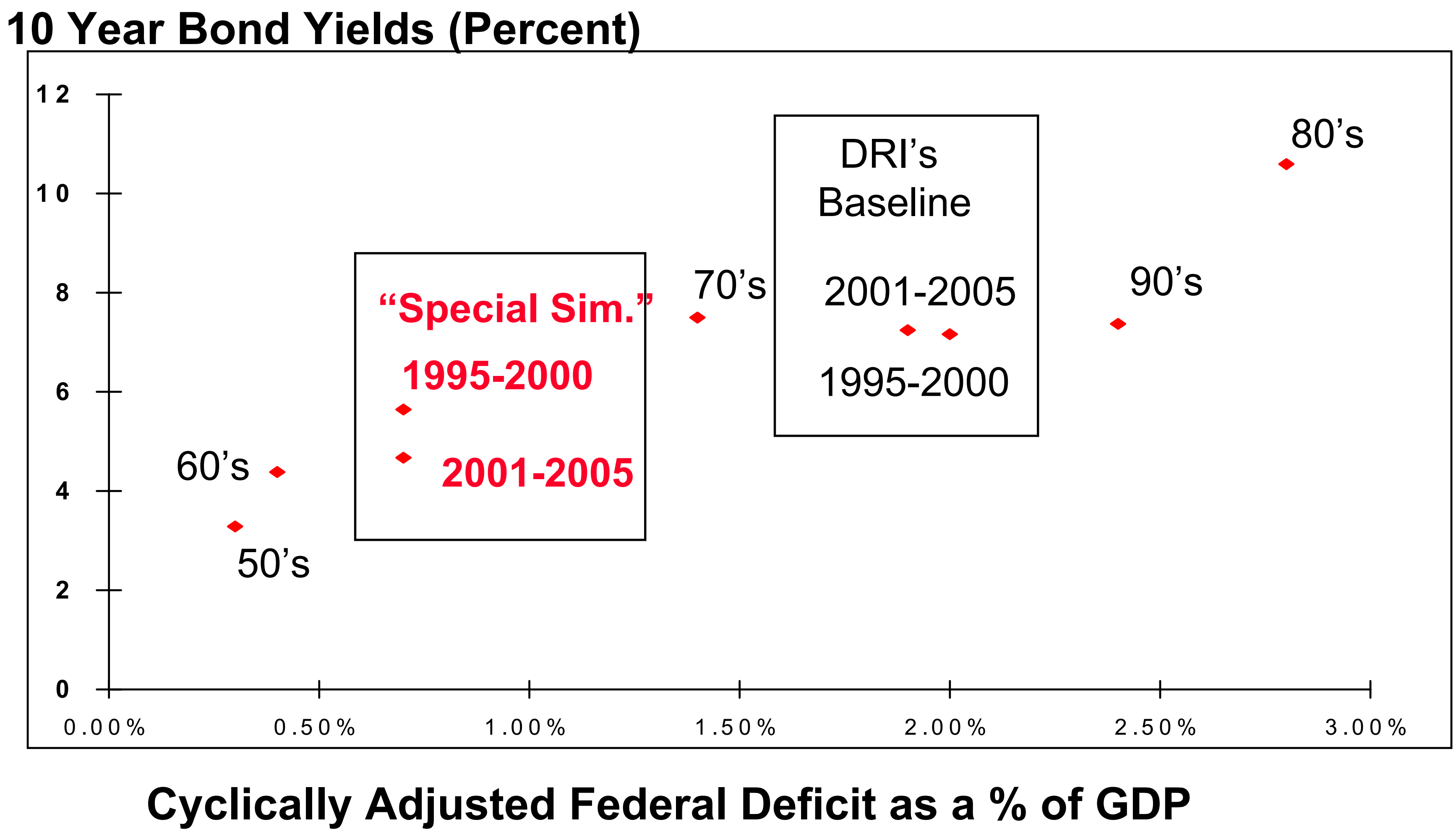
($ Billions, Average change from baseline)

	1996	1996-2000	2001-2005
Federal Taxes	-24	-15	-32
Federal Spending			
Defense	-9	-19	-28
Non-defense (excl. Interes	-42	-65	-102
Net Stimulus (+)/Restraint	-28	69	-98
Interest Savings	-5	-30	-106
Federal Deficit	33	99	204
Federal Debt (1995 $ per Household)			
	-280	-1803	-7475

This Budget Balancing Produces Interest Savings Equal to Program Savings by 2003

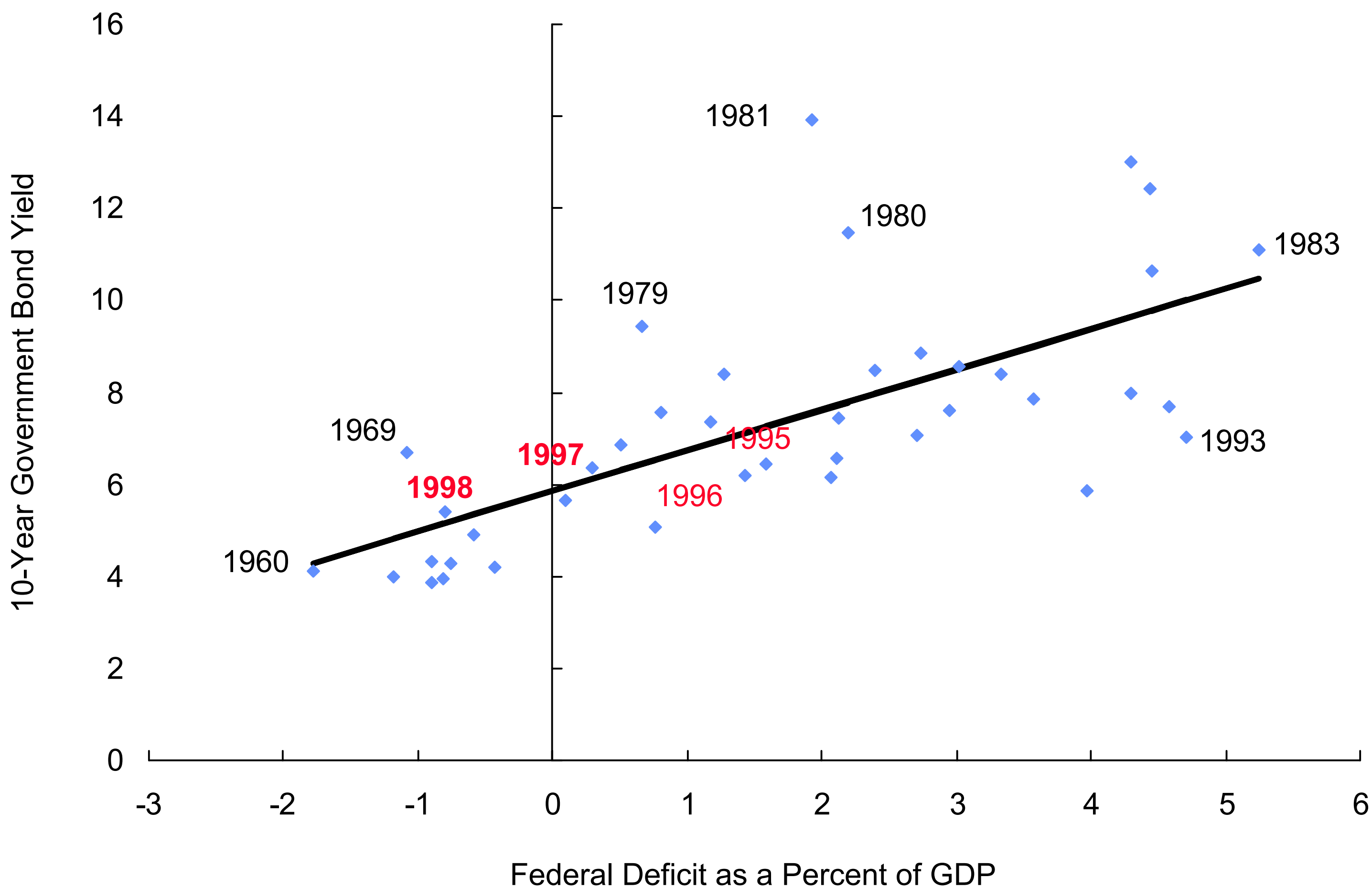


Aggressive Federal Borrowing Forces High Bond Yields and a Balanced Budget offers a Return to better norms



The 1995-1998 Bond Rate Declines Match the Expected Impacts

The line is the 1959-96 fitted relationship between yields and deficits



Interest Rates and Budget Deficits: The Numbers Look Like the 50's & 60s

	Market Rates			Federal Deficit/GDP	
Average	**10-yr.**	**F.Funds**	**T-bills**	**Actual**	**Cyclically Adj**
50's	3.28	2.50	2.00	0.0%	0.3%
60's	4.67	4.18	3.98	0.2%	0.7%
70's	7.50	7.10	6.29	1.7%	1.4%
80's	10.60	9.97	8.82	3.6%	2.8%
90-95's	7.37	5.15	4.95	3.2%	2.4%
	Baseline				
96-2000	7.17	5.27	4.90	2.5%	2.0%
2001-2005	7.24	5.25	4.86	2.4%	1.9%
	Special Sim. with Balanced Budget in 2002				
96-2000	5.64	4.09	3.87	1.2%	0.7%
2001-2005	4.39	3.09	2.98	0.0%	0.4%
	Actual 95-98 Outcome				
Average	**6.15**	**5.48**	**5.09**	**1.0%**	**0.9%**
1998	**5.26**	**5.35**	**4.78**	**-0.8%**	**-0.1%** (**Surpluses!**)

Lower Interest Rates Are an Absolutely Logical Impact of Budget Balancing

1. **Interest rates are the "price" of national savings**; when savings are scarce, rates are high, and when savings are plentiful, rates are low.
2. **Scarcity, thus rates, reflect both demand and supply. Budget balancing improves both, creating a double downward pressure on interest rates**.
3. Obviously, **if the federal government is borrowing less, the demand for savings is lower by definition**. The drive toward a balanced budget reduces the annual borrowing (the deficit) and the accumulated borrowing (the debt). The demand for savings is lower, hence rates must be lower too.
4. **If taxes have not been raised to reduce the federal deficit, then private sector saving (supply) will be unchanged, or higher** to the extent that gross income is higher and thus supports more saving.
5. **The Federal Reserve should be expected to expand the supply of funds, without creating any additional inflationary pressure.** First, short-term credit stimulus is needed to offset fiscal restraint so as to keep unemployment from rising. Second, the investment and other genuine supply side stimulants allow the Fed to target more rapid real growth in the economy. Higher real growth in the nation's supply potential justifies greater liquidity without fear of extra inflation.

The DRI Special Simulation Assumed the Federal Reserve Added Only As Much Extra Liquidity As Was Consistent with No Change from the Baseline Inflation Rates

- **The greater liquidity added in the special simulation..**
  - **offsets the restraint from fiscal policy,**
  - **and reflects the more rapid growth in the supply side of the economy.**
- **In addition, we created <u>alternative scenarios</u> in which the Federal Reserve took <u>no action to boost liquidity</u>.**

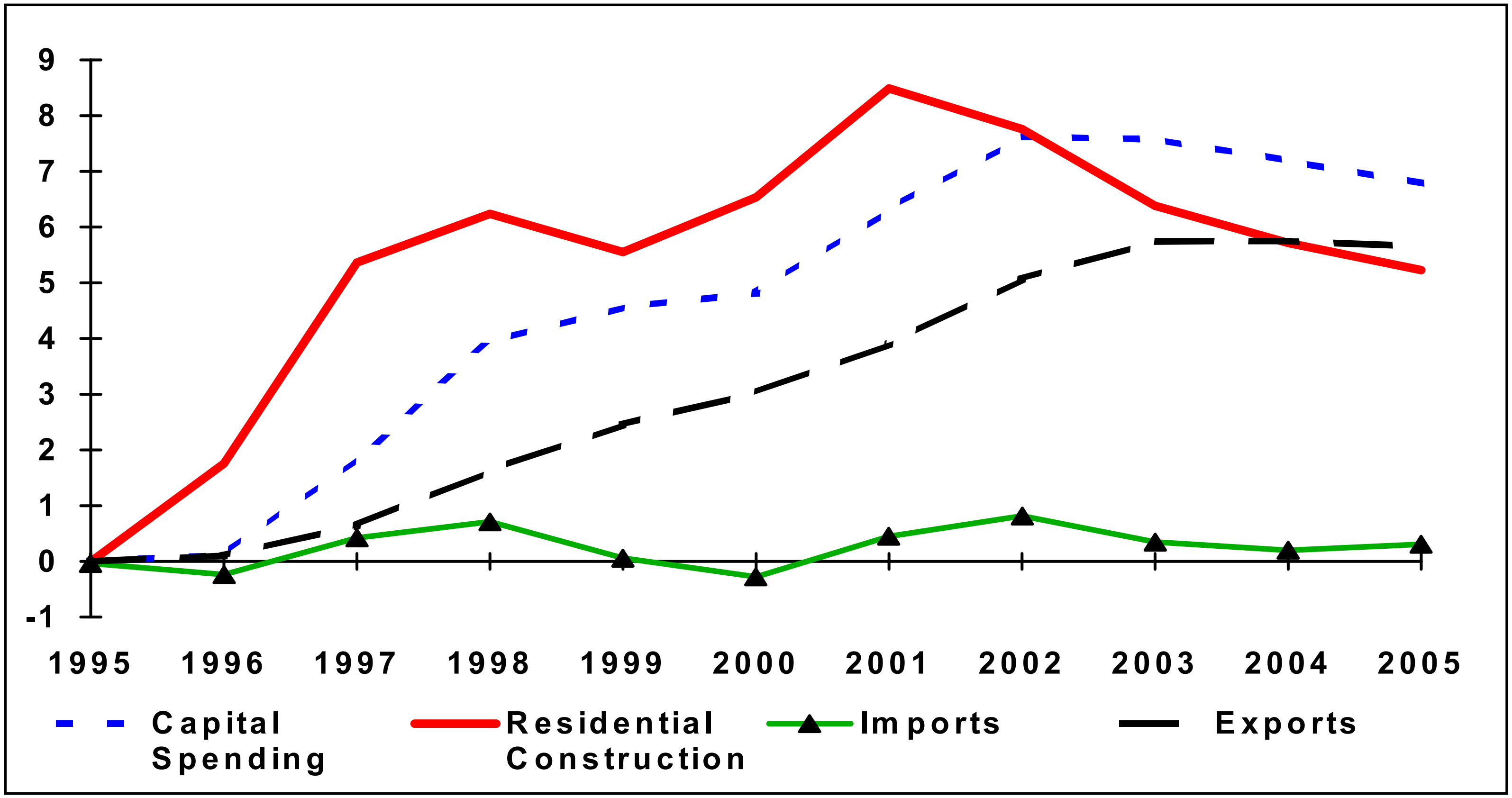
Economic Performance with Alternative Federal Reserve Responses to New Spending and Tax Policy

Changes Relative to Baseline

	Federal Funds Interest Rate		Unemployment Rate		CPI Inflation Rate	
	2002	96-2002	2002	96-2002	2002	96-2002
If Federal Reserve Does Not Boost Bank Reserves	-.69	-.44	0.4	0.4	-0.5	-0.2
If Fed. Reserve adds Bank Reserves, Targeting Baseline Inflation Rate	-1.70	-1.20	-0.4	-0.1	0.1	0.1

Once Again, the Analysis Confirms This Budget-Balancing Need Not Be Painful: As the Government Shrinks, Interest-Sensitive Sectors Will Rise

(Real Spending by sector, percent change relative to baseline)



Summary of Sectoral Impacts
(% Difference from Baseline)

GDP and Sectors

	1996	1996-2000	2001-2005
	-------	-------------	--------------
Real GDP	-0.1	0.5	2.2
Consumer Goods	0.0	- 0.1	0.1
Capital Spending	0.1	3.1	7.1
Residential Construction	1.8	5.1	6.7
Federal Purchases	-4.1	-6.5	-7.8
Exports	0.1	1.6	5.2

The Estimated Potential For More Workers and Higher National Income

Impact of the Labor Force Expansion Assumptions on Economic Performance
(comparing the special sim with labor force changes to the special sim without)

	1996	2000	2005
Assumed Gain in Full-Time Equivalent Workers due to:			
Welfare Reform	150,000	1 million	1.5 million
Lower Marriage Penalty	200,000	400,000	500,000
Higher Earnings Limit	200,000	300,000	400,000
Total	550,000	1.7 million	2.4 million
Economic Feedback of More Workers and Hours			
Real GDP Gain ($Billion, 1987 Prices)	$6	$27	$75
Cumulative Percentage Gain	0.1%	0.5%	1.1%

Estimated Supply-Side Benefits of Our Implementation of Balanced Budget in 2002

Average Annual Growth Rates

	Baseline		Budget Proposals		Improvements	
	95-2000	**2000-05**	**95-2000**	**2000-05**	**95-2000**	**2000-05**
Labor Force	1.39	1.25	1.64	1.33	0.25	0.08
Fixed Investment	4.62	4.13	5.6	4.52	0.99	0.39
Bus Cap Stk	3.15	2.67	3.55	3.37	0.40	0.70
Ind R&D Spend	4.49	2.76	5.84	2.98	1.35	0.22
R&D Capital Stock	2.58	2.52	2.92	2.92	0.34	0.40
Potential GDP	2.48	2.25	2.73	2.55	0.25	0.30
Output per Hour	1.49	1.28	1.51	1.5	0.01	0.22

Achieved *Benefits of the Implementation of a Balanced Budget by 1997*

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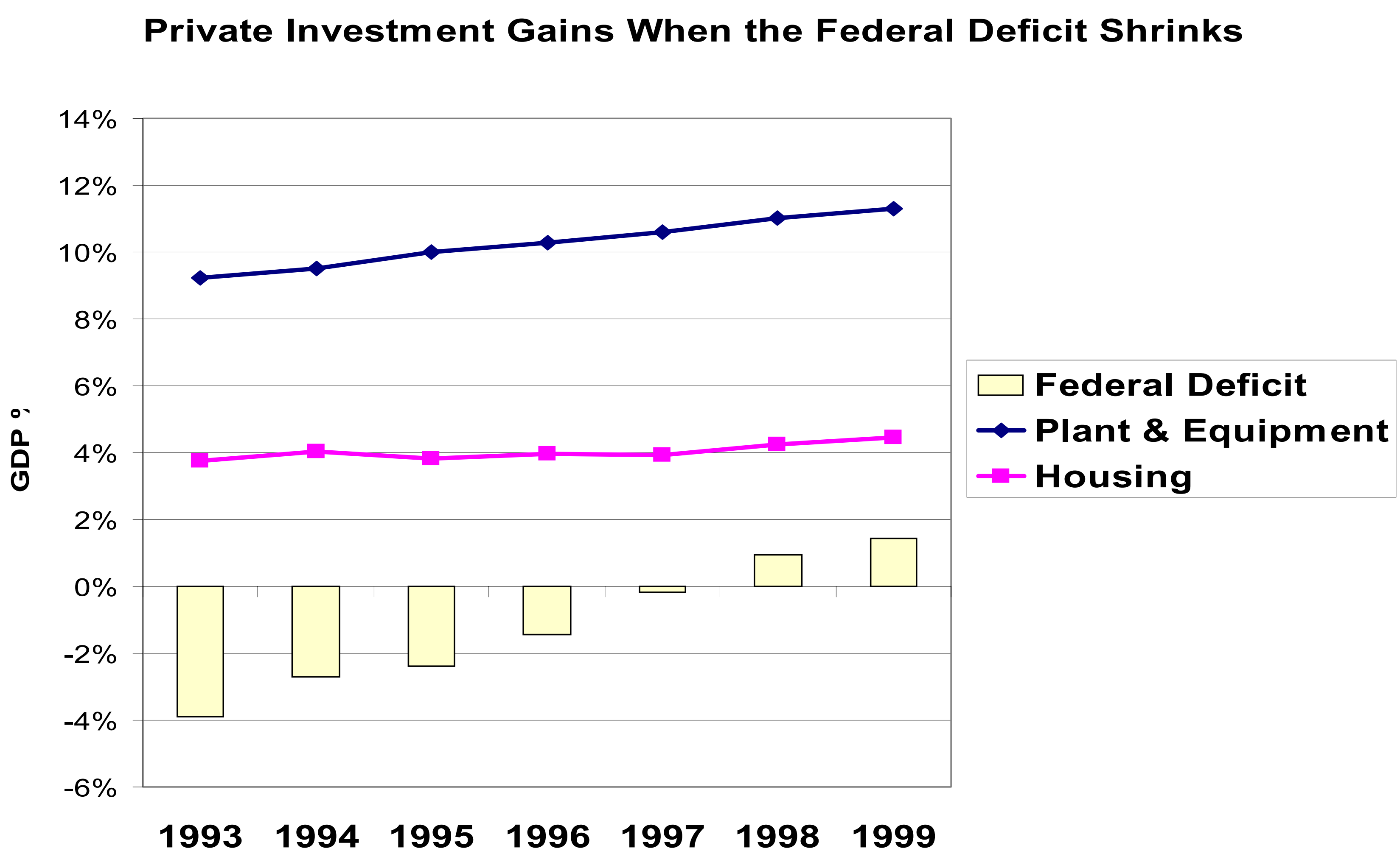

WE CAN DO BETTER

Diligent pursuit of budget balance can boost real growth rates significantly, adding 2% to national output by 2002 .

Eliminating the deficit need not cause a recession if the Federal Reserve provides moderately greater liquidity.

A virtuous cycle of lower interest rates and lower federal debts ease the challenge of balancing the budget.

Welfare reform and tax changes can motivate more citizens to work, contributing to their prosperity and the nation's.

Education reform and training efforts can boost productivity of workers who might otherwise face stagnating living standards.