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Issue Brief

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THE BALANCED BUDGET PROPOSAL: SOME MACROECONOMIC IMPLICATIONS

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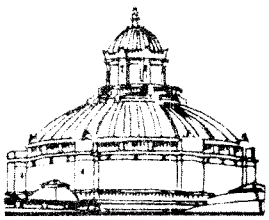

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ISSUE DEFINITION

Several proposals have been made, on the basis of strong and persistent public sentiment, to prohibit the Federal Government from running a budget deficit in any fiscal year. Such a restriction on the fiscal activity of the Federal Government would profoundly alter the role of the Federal Government in the Nation's economy, inasmuch as only two of the past twenty-seven fiscal years' budgets have recorded a surplus. For the most part, however, the proposals merely declare a criterion of performance -- usually to require that, on the unified budget basis, Federal budget outlays shall not exceed receipts, although some recent proposals are constrained by mandating also an upper limit on the level of Federal revenues. This mini brief outlines some possible macroeconomic implications of observing a statutory or constitutional commitment to balance the Federal budget. It does not address the legal questions about the proposals or their implementation, nor the economic and political questions related to decisions about the level of Federal revenues or expenditures. On the latter, its analysis refers to revenue and expenditure levels, in relation to total national product, typical of recent years. Finally, the mini brief does not attempt to analyze the effect of various escape clauses attached to several proposals.

BACKGROUND

The Federal budget is unlike other budgets

The Federal budget resembles other budgets only in that it is an economic prospectus, a declaration of intentions. It differs from State and local budgets in that most subordinate governments differentiate current account budgets from capital budgets, requiring in many instances balance in the current accounts, whereas the Federal Government makes no distinction between outlays for current expenses and outlays of the nature of investment in social capital. By standards of Federal accounting, many States and municipalities, while adhering to the requirement of current-account balance, would be in budgetary deficit if they were to consolidate their budgets, since borrowing creates a deficit on capital account. For the same reason, vigorously growing corporations, in issuing new debt in excess of their net income, are practising what is called deficit spending in reference to the Federal Government. For most households, too, the first purchase of a home associated with a mortgage commitment is relatively a huge excess of outlays over receipts in the year of its acquisition and hence is also a cause of deficit spending. It is true that the creditworthiness of States, localities, corporations, and households places limits on the scale and terms on which they are able to borrow, and that no similar short-term constraint applies to the Federal Government. There are long-term limits, however, and the ability of subordinate borrowers to service debt finds its counterpart in the willingness of the Federal Government to impose taxes to raise revenues.

Federal revenues and expenditures cannot be precisely controlled

The President's budget is presented to the Congress each January, more than 8 months before the beginning of the fiscal year to which it applies. Its taxing and spending proposals determine the estimates of revenues and expenditures on the basis of explicit economic presumptions. Whether the actual course of events will conform to these presumptions cannot be assured.

If the President presents a budget in balance, and even if such changes as the Congress makes leave the budget in balance at the time of the Second Concurrent Budget Resolution, which is required before the beginning of the fiscal year, there is still no assurance that the budgetary outcome will result in a balance. This is due to such factors as the unpredictable timing of actual expenditures, particularly on long lead-time projects and multi-year programs; the existence of open-ended programs such as unemployment assistance; and the variability associated with commitments, such as the payment of interest, at an unknown future rate, on the Federal debt. Moreover, the actual Federal outlays during the fiscal year will be affected by unspent authority enacted in earlier years. And the budget numbers are, in some programs, conditioned by past commitments to expenditures that are "relatively uncontrollable," i.e., require congressional action for any change in that fiscal year. Finally, the budget document reports certain activities that are by law "off-budget," most of these outlays being excluded from the unified budget totals.

Most of all, the uncertainty of the Federal budget outcome is due to the impact of the state of the economy on the budget. For example, personal and corporate income levels affect income tax receipts. The level of unemployment affects payments of assistance. And some grants and subsidies vary in response to economic conditions, State and local government expenditures and receipts, etc. The intent of many of the programs most affected by the state of the economy is not only that they incur certain expenditures or raise revenue from specified sources, but that they act as automatic stabilizers of the economy, causing Federal outlays to rise and receipts to fall if economic activity is reduced, and vice versa.

Consequently, the budget figures presented initially by the President are directly affected not only by the programmatic proposals but also by the underlying assumptions about the future performance of the economy. The crucial importance of these assumptions is seldom emphasized, largely because every Administration has a political interest in projecting the success of its economic policies. The result is that relatively few allowances are made for adverse economic developments. The actual budgetary deficit tends in most cases to exceed, rather than fall short of, the initial expectations, even if no programmatic changes are made in the interim.

Required budgetary balance may affect the stability of the economy

A rigid adherence to budgetary balance could severely constrain the stabilizing influence of fiscal policy. For if lower general economic activity generated lower Federal tax receipts and threatened to cause a budgetary deficit, the commitment to balance the budget would necessitate a reduction of expenditures or an increase in taxes, either of which would further reduce economic activity -- a destabilizing process. Equally, if

there were the same obligation to avoid surpluses, higher income and higher tax receipts might require high expenditures at the very time when stabilization policy would call for less, or at least not more, Federal spending. Alternatively, higher tax receipts could be considered as a reason for a cut in tax rates, a stimulative action at a time when restraint might be more appropriate.

Federal government expenditures on goods and services generate incomes, and Federal Government transfers to State and local governments and to private individuals provide purchasing power to be exercised usually within a short period of time. Federal receipts of all kinds withdraw purchasing power from the private sector. However, the important consideration is what all government activity, and not just the Federal budget alone, is doing to the economy. From the viewpoint of the private sector of the economy, the effects of Federal fiscal policy may be enhanced or countered by the fiscal activities of State and local governments. It is noteworthy that, on the basis of the national income and product accounts for calendar year 1984, the Federal Government deficit of $171.5 billion, was partially offset by a State and local government surplus of $53.0 billion. On balance, the whole government sector was continuing to stimulate economic activity to a substantial degree, especially in view of the relatively strong recovery that had begun in late 1982. (However, the emergence of a very large international trade deficit suggests that foreign suppliers of U.S. commodity imports were major beneficiaries of this stimulus.)

Congressional action to balance the budget is subject to both limitations and political perceptions

There is no way to estimate by what means the required Federal budgetary balance would be achieved. But some account has to be given to the fact that "relatively uncontrollable" outlays (requiring congressional action to change an on-going program) account for about three-quarters of total outlays and, among these, open-ended programs involving payments for individuals, such as Social Security, account for almost one-half of total outlays. Of the "relatively controllable" outlays, well over half are found in the defense budget. It is also noteworthy that the budgetary process sometimes takes longer to decide on major changes in outlays than changes in taxes -- a situation that might move the Congress to raise taxes rather than cut spending, the opposite reaction to the intent of many of those favoring a balanced budget. There is likely to be asymmetry in congressional responses, for tax cuts and expenditure increases cause less difficulty than tax increases and expenditure cuts.

It is possible, of course, that the Congress could respond to the difficulty of reducing expenditures by altering the coverage of the budget. As mentioned earlier, there are off-budget Federal entities, Federally owned and controlled but with most of their outlays excluded from the unified budget totals, and not subject to the ceilings set by the congressional budget resolutions. Their status is created, and can be changed, by law. While most of them are involved in loan programs, Congress could choose to extend the concept of an off-budget entity.

In addition, the regulatory activities of the Federal Government are capable of being conducted in such a fashion that, instead of incurring budgetary costs, they could impose costs on the private sector. An immense variety of options exists, ranging from preventing layoffs of employees (and

avoiding payment of unemployment benefits) to mandating higher product prices instead of subsidizing production.

The change in budgetary procedures will not leave monetary policy unaffected

There is a continuous relationship between budgetary and fiscal policy, Federal debt management, and monetary policy. The likely consequences of a commitment to a balanced budget would be a diminution of the power and scope of fiscal action, and a consequent increased reliance on monetary policy, especially in the event that the loss of fiscal discretion has a destabilizing effect on the economy. It should not be forgotten, however, that monetary policy cannot be a complete substitute for discretionary fiscal policy. Both budgetary expenditures and taxes are able to perform specific distributive and allocative functions, channelling resources to certain types of people, organizations, industries, or locations, and withdrawing resources from certain others. Monetary policy cannot do this, and even such a proposal as credit allocation cannot attain anything like the purposefulness of budgetary action. Moreover, the budgetary process involves open political deliberation, whereas monetary policy is conducted by the independent Federal Reserve System under conditions of strict confidentiality, though Congress is entitled to oversee the general performance of the System. It is not necessary that this independence should continue. On the contrary, the balanced budget might endow the management of monetary policy with such enhanced and critical power that political pressure would curb the independence of the Federal Reserve System, with uncertain consequences for the performance of the economy.

Ad hoc budgetary balance and surplus

It must be emphasized that nothing in this analysis runs counter to the view that at some times the budget should be balanced or in surplus; the desirable budgetary outcome depends on the economic circumstances. However, a rigid requirement that the Federal budget should be balanced carries the risk that this might be achieved by measures whose associated costs to the Nation, in terms of equity, efficiency, and economic stability, had not been given adequate consideration.

The budgetary outcome for FY84, ended Sept. 30, 1984, is a still massive deficit of $175.3 billion, albeit smaller than the $195.4 billion of FY83. In the absence of strong and prompt action to reduce expenditures or increase tax revenues, there is little prospect that economic growth will cause the FY85 deficit to be substantially less than $200 billion. This is because the deficit is no longer merely a natural accompaniment of cyclical downturns, but a manifestation of a new tendency for Federal expenditures to grow at a faster rate than Federal revenues in both good years and bad.

There are many reasons for this development. On the expenditure side, despite major reductions in some social programs, the increase in real defense spending and the commitment to indexing of many "entitlement" programs are two sources of expenditure growth. Despite the fact that interest rates have declined by 2-3 percentage points in the past 4 months and are now 3-4 percentage points below those of a year ago, Federal debt service, on a larger total of debt, is unlikely to be a smaller proportion of total budgetary expenditures. On the revenue side, budgetary legislative

action during 1982 to increase tax collections and reduce some tax favors granted in 1981 is far from sufficient to recoup the earlier concessions.

Even good economic news may, in the short run, yield less than might be expected in the reduction of the deficit. There has been a considerable and well maintained reduction in price increases since 1981. The annual rate of increase in the consumer price index, less than 4% in both 1982 and 1983, remained at 4% in 1984. Yet this moderation of price increases in itself is likely to reduce revenues more, and more promptly, than expenditures, even if it promises a better future economic performance.

The magnitude of the deficit, above all, demonstrates how far it is necessary to go to achieve a balanced budget. The Administration's present forecast for FY85, and its outlook for FY86, are predicated on an annual real rate of growth of 4%. The budget proposals for FY86, including substantial but as yet undetermined spending cuts, would then envisage a decline in the deficit over the next few years. The annual rate of real growth in gross national product in the year ended in June 1985 was actually less than 2%. So, in the absence of further cuts in spending or of decisions to raise new revenues, it appears that a very considerable expansion in economic activity would be needed to balance the budget even in 5 years' time.

Such an economic environment casts doubt on the realism of proposing a quick return to budgetary balance, however much that budgetary outcome might be desired as appropriate to the current needs of, and pressures on, the economy. Of course it is possible to forecast an outcome closer to balance by using economic presumptions that are overly optimistic; but that would do nothing to assure its achievement. The basic question is whether giving first priority to a balanced budget as a goal in itself would cause the economy to weaken and become less manageable. The real issues require decisions on whether the chosen levels of revenues and expenditures, and their prospective changes in future years, are consistent with the lasting need for fiscal constraint. It is necessary also to ask whether plans for Federal expenditures are compatible with resource availability and the financial environment. If not, the risk is that a commitment to refrain from any tax increases, and insufficient constraints on total Federal spending, will frustrate the desired reduction in the deficit. A widening deficit in future, when the economy is moving closer to full employment of its resources, would assuredly threaten to preempt the savings necessary to sustain the greater private demand for investable funds. This threat is all the more severe because, since 1983, U.S. domestic savings have been supplemented by a massive inflow of foreign capital whose continuation on the same scale cannot be assumed.