

Fiscal Contraction or Fiscal Expansion in the US: Which Will Promote Growth and Employment?

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Late July 31st 2011, President Obama and leaders of both political parties in the US Congress finally agreed on a framework that would increase the Government's ceiling on its debt and institute significant budget cuts over the next 10 years.

About \$917 billion in deficit reduction over 10 years was agreed in July with an initial modest cut of only \$12 billion proposed for 2012. In addition, a Special Joint Committee of Congress was set up to hammer out agreement on further cuts of up to \$1.5 trillion (or compensating revenue increases).

Should this Committee be unable to reach agreement on a package of cuts in expenditures and increases in taxes, the further cuts of \$1.5 trillion would automatically be implemented. Half of the cuts would be on the budgets for national security and defense. Medicare would also be subject to some expenditure reductions.

So, the worst-case scenario over ten years, starting in 2012, could be a total of about \$2.4 trillion in budget cuts. What could be the economic consequences of such a scenario? And what could be an alternative approach?

In order to answer these questions, we employed the *State of the World Economy* global macroeconomic model in order to construct a plausible scenario through 2021. See www.soas.ac.uk/cdpr/expertise/worldmodel for further details on the model, which is designed primarily to construct medium-term policy-oriented global scenarios. To function effectively, the model is calibrated to simulate historical trends from 1970 to 2009. It is not a general equilibrium model.

The Budget-Slashing Scenario

For what we call our 'budget-slashing' scenario, we arbitrarily assigned the same large magnitude of cuts each year over the nine years after 2012. The resultant total, including the modest cut for 2012, approximated the agreed target of \$2.4 trillion.

We also assumed that some of the cuts in the budget would take the form of asset transactions, such as selling off government assets, or gains in net government income because of reductions in transfers.

In order to set this scenario within a realistic global framework, we also assumed fiscal tightening in other developed countries, starting with Europe. We programmed the model to reduce the ratio of government debt to GDP to a realistic specific target for each bloc or country. For example, the debt-to-GDP ratio was programmed to drop to 50% for both Central and Northern Europe, to 70% for the United Kingdom, to 80% for Southern Europe, and to 120% for Japan.

For this Development Viewpoint, we focus on the results for the US economy, not those for the other blocs and countries.

When our assumptions were fed into the model, the result was an immediate sharp recession in the US in 2013, with GDP growth dropping to a negative 3.4%. Thereafter, growth recovered meekly,

reaching a feeble 1.5% rate in 2016 and 1.8% in 2021, the final year of the scenario. For the whole period of 2012-2021, GDP growth averaged only about 1.3% (see the shaded area in Figure 1, next page).

What about employment? Not surprisingly, it dropped significantly. The ratio of the employed to the working-age population declined progressively from an already low level of 65.7% in 2012, in the wake of the Great Recession, to 63.2% in 2021.

The proposed budget cutting did succeed in reducing the relative importance of government expenditures. The ratio of such expenditures to GDP declined from 20.3% in 2012 to 16.7% in 2021.

What about the other major sources of aggregate demand? The ratio of consumption to GDP declined slightly, from 74% to 73%. However, the ratio of private investment to GDP rose from about 10% in 2012 to 13% in 2021 (Figure 2, next page).

But price inflation barely stayed above zero (i.e., deflation) from 2016 onwards. The current account deteriorated as the real exchange rate appreciated by about 13% between 2012 and 2021. Hence, it is not surprising that, as a ratio to GDP, the current account still registered a deficit of -2.2% in 2021. It is also not surprising that GDP growth remained so lacklustre through 2021 since most of the core components of aggregated demand declined.

But what about the government deficit and the total debt stock, the explicit targets of expenditure reductions? Net government lending as a ratio to GDP did indeed drop drastically, from -7.8% in 2012 to a mere -0.5% in 2021. And the ratio of total debt to GDP was correspondingly reduced, from 85% in 2012 to 63% in 2021.

So, the budget-slashing strategy was successful on its own terms—namely, reducing the Government's annual deficits and its debt stock. But these targets were achieved at the expense of deterioration in aggregate demand, economic growth and employment.

The Fiscal-Stimulus Scenario

Is there a viable alternative strategy to drastic slashing of government expenditures that could achieve both a reduction in US government debt and an increase in employment-creating economic growth? This objective guides the logic of our alternative 'fiscal-stimulus' scenario, which seeks to expand government expenditures instead of cutting them.

This alternative scenario contains a few key assumptions. Our central assumption is that there is a growth rate of government expenditures of 5% per year. We also assume that increases in government expenditures have a positive, though moderate, impact on private investment. Thus, the underlying assumption is that the character of government expenditures is designed precisely in order to boost private investment.

In addition, we assume a targeted increase to 21% in the ratio of net government income to GDP. This target is comparable to the average

levels of government income in other developed economies. The reason for this assumption is that low revenue levels have been a major cause of rising US government deficits.

Figure 1: Growth Rate of GDP 1990-2021, United States

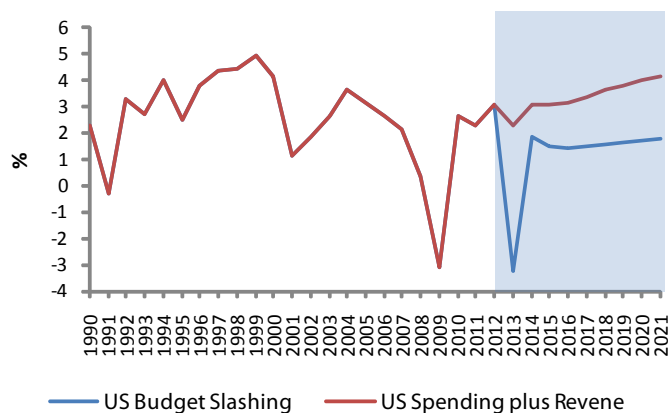
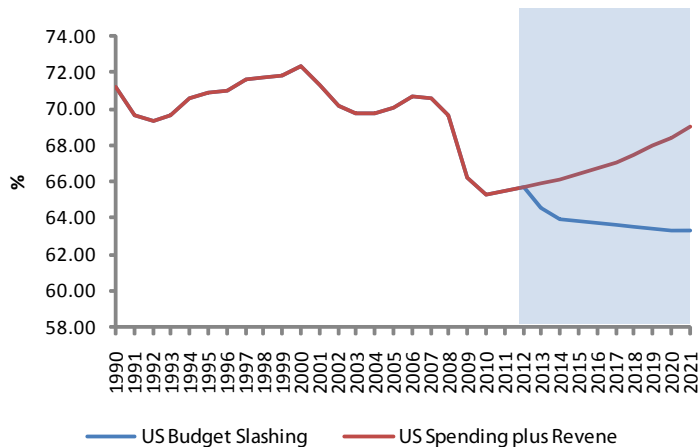


Figure 2: Employment Rate 1990-2021, United States



This income assumption represents a decisive break with recent US history, in which government income as a ratio to GDP was allowed to languish at a low level of about 15%. For instance, movement towards our target would benefit immediately from letting the lavish pro-rich Bush-era tax cuts expire.

In order to prevent deterioration in the current account, we also assume that the nominal exchange rate of the US dollar is adjusted to hold the real exchange rate relatively constant. Note that the policies in other developed countries are the same as in the first scenario.

How do the results produced by the 'fiscal-stimulus' scenario compare to the results produced by the 'budget-slashing' scenario?

After dipping slightly from 3% in 2012 to 2.4% in 2013, the growth rate of GDP progressively increases thereafter, reaching 4.1% in 2021. For the whole period of 2012-2021, growth averaged 3.4% (in contrast to 1.3% for the 'budget-slashing' scenario).

Employment improved markedly in this scenario. The ratio of the employed to the working-age population increased from 65.7% in

2012 to virtually 69% in 2021. Note, however, that the 2021 level only reinstated the level of employment achieved before the Great Recession.

Increases in employment were also driven by rising private investment. The ratio of such investment to GDP reached 15% in 2021, above the level of 13% attained in the 'budget-slashing' scenario.

As domestic aggregate demand increased, driven mostly by government expenditures and private investment, the current account moderately deteriorated. Its deficit as a ratio to GDP increased from -2% in 2012 to about -3% in 2021 though the latter level remained much below pre-crisis levels of about -5%.

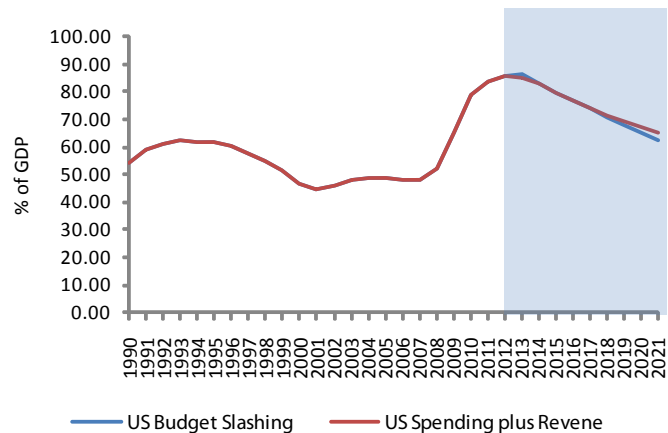
Holding the real exchange rate relatively constant helped to prevent the current-account deficit from becoming a significant drag on demand. Since price inflation only exceeded 2% by 2021, the adjustment of the nominal exchange rate did not need to be drastic.

In contrast to the downward trend for 'budget-slashing', government expenditures as a ratio to GDP increased significantly in this scenario, reaching 23.5% in 2021, up from a level of 20.3% in 2012. However, the ratio of net government income to GDP also increased, reaching the target of 21% in 2021.

Hence, net government lending as a ratio to GDP was reduced from -7.8% in 2012 to -2.5% in 2021. This is a credible performance—though not as drastic as the result in the 'budget-slashing' scenario.

A major result for the 'fiscal-stimulus' scenario is that it achieved a level of debt-to-GDP that was similar to the level attained by 'budget-slashing'. For the former the ratio dropped to 65% in 2021 while for the latter the ratio declined to 63% (Figure 3).

Figure 3: Government Debt as % of GDP 1990-2021, United States



Overall, the outcomes achieved by the 'fiscal-stimulus' scenario appear superior. This is certainly the case for performances on growth, private investment and employment. Also, the level of government debt (a principal objective of budget negotiations in the US) is similar in both scenarios.

Though yearly net government lending is more negative in the 'fiscal-stimulus' scenario, the levels of both government expenditures and income are more comparable to those for other developed economies.