BALANCING THE FEDERAL BUDGET: ECONOMIC RATIONALE AND ISSUES

Glenn H. Miller, Jr.
Federal Reserve Bank of Kansas City

This paper will touch only the surface of the many economic issues surrounding the question of federal budget deficit reduction. It will, however, highlight some of the major issues facing fiscal policymakers: Why deficit reduction is important, some of the options available for reducing the deficit, and the potential consequences and benefits of such action.

The Large Size of Recent Deficits

The deficit in the federal budget has averaged more than $180 billion annually over the last four full fiscal years. In fiscal 1985 the deficit reached a record $212 billion. The deficit for fiscal 1986 is estimated to be about $225 billion—a new record. The dollar amounts of these recent deficits are substantially greater than those of any other period in U.S. history. And while the American economy is also larger now, federal budget deficits have increased proportionately more than the economy has grown. From fiscal 1982 through fiscal 1985 the deficit averaged 5.2 percent of gross national product (GNP). At no time since the end of World War II has the budget deficit been so large relative to the size of the economy.

We know that cyclical changes in economic activity automatically affect the size of the actual budget deficit. For example, when the economy goes into recession, tax receipts fall and certain kinds of outlays—for example, food stamps and unemployment compensation—increase. As a result, the deficit increases—not because fiscal policy actions have been taken but simply because the budget has reacted automatically to the weakening of the economy. A similar response in the opposite direction occurs in a business upswing. As the economy recovers and expands, revenues increase, certain outlays decline and the deficit falls. Thus a cyclical component of the budget deficit can be identified.

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Economic policymakers and economists have learned that budget policy and its economic significance are better understood by looking at a noncyclical measure of the deficit than at the actual deficit. Therefore attempts have been made to adjust for the cyclical component of the budget deficit and thus to produce a cyclically-adjusted measure of the deficit, often referred to as the structural deficit. Several different measures of the noncyclical or structural deficit have been developed in order to address different analytical needs (Congressional Budget Office 1984, pp. 103–118). I will use one such measure to illustrate how the structural deficit may be used in fiscal policy analysis and prescriptions.

This measure of the structural, or cyclically-adjusted, deficit is the standardized employment deficit (formerly called the high employment deficit and, earlier, the full employment deficit). The standardized employment deficit is an estimate of what the budget surplus or deficit would be if the unemployment rate were at some benchmark level, such as the level associated with no change in the inflation rate, and at the corresponding estimated level of GNP. If a deficit existed at those levels of the unemployment rate and GNP, it would be characterized as a noncyclical or structural deficit. If cyclical weakness in the economy produced a level of actual GNP below the benchmark level (a GNP gap), then a cyclical deficit would automatically appear. The resulting actual deficit would be larger than the structural deficit by the amount of the cyclical deficit.

The Congressional Budget Office (CBO) currently estimates the standardized employment deficit at a benchmark unemployment rate of 6 percent. Using estimates based on that measure, the structural deficit is estimated to have been more than ten times larger in fiscal 1985 than in fiscal 1981, a period during which the measured deficit increased less than four-fold. The performance of the cyclical deficit is as expected in this period. Its proportion of the total deficit, about three-fourths in the recession years of 1981 and 1982, declined through the years of recovery and expansion to about a fifth in 1985. Continued expansion of the economy until the unemployment rate falls to 6 percent, thus wiping out the cyclical deficit, would still leave a large structural deficit unless fiscal policy actions are taken to reduce it.

Consequences of Large Deficits

It is clear that federal budgets have been extraordinarily large in the most recent five fiscal years, including fiscal 1986. They have been large in absolute terms as well as in relation to the size of the economy. They have been large actually and remain large when cyclically adjusted. And unless actions are taken by fiscal policymakers there is a reasonable concern that they will remain large in the years ahead.

What are the consequences, both recent and expected, of large deficits for the U.S. economy? In the short run, the large increases in the structural deficit represented a highly expansionary fiscal policy that contributed substantially to the economy's recovery from the 1981–82 recession and to the subsequent expansion. But while the consensus is not complete, most economists and economic policymakers still appear to believe that large federal budget deficits are a matter for concern in the longer run because they lead to higher real interest rates, with serious consequences for the U.S. economy (Congressional Budget Office 1984, pp. 67–71, 99–102).

Much of the concern exists because interest rate pressures are viewed as leading to a crowding out of certain kinds of economic activity. Higher interest rates would be expected to affect interest-sensitive sectors of the economy such as residential and business investment. As the federal government increases its demand for credit in the nations' credit markets, where supplies are limited by the amount of national saving, interest rates are driven up and interest-sensitive private spending is crowded out. Because most of that spending is for investment purposes, and most federal spending is for consumption, the composition of total spending is changed. Capital formation is reduced, leading to lower productivity and reduced real output growth in the future. This analysis supports the view that, primarily because of the large federal budget deficits, the United States is now consuming beyond its means at the expense of the living standards of future generations.

Another kind of crowding out has been observed, however, in the early 1980s—a crowding out of U.S. export industries and of U.S. industries that compete with imported goods. The process may be briefly described as follows. Interest rates in the United States have been pushed up by the borrowing pressure exerted by the federal government. As a result, U.S. interest rates rose relative to interest rates abroad, leading to increased foreign demand for U.S. investments and to capital flows into the United States. These actions pushed up the foreign exchange value of the dollar. The stronger dollar, in turn, lowered the prices of imports into the United States and increased the prices of U.S. exports. As would be expected, U.S. exports declined and much of the growth in U.S. domestic demand was met by increased imports. Both import-competing U.S. producers and U.S. exporters suffered as our balance of trade worsened. In this sense, federal budget deficits were to a great extent responsible for our foreign trade deficits and the crowding out of net exports. Indeed, many observers—including Federal Reserve Chairman Paul Volcker—have noted that the proper area of concern was not *the* deficit, but the *twin* deficits in the federal budget and in our trade accounts. At the same time, however, the capital inflows from abroad meant that foreign savings were helping fill U.S. credit demands and thereby keeping interest rate increases smaller than they otherwise would have been.

In summary, then, large federal budget deficits lead to concerns about crowding out of domestic private investment and of U.S. net exports.

Efforts to Reduce the Deficit

In spite of various revenue increases and spending reductions, the federal budget deficit has been both high and rising through fiscal 1986. Within the last twelve months, however, stronger efforts to reduce the deficit have made an appearance, including the passage of the Gramm-Rudman-Hollings Act (GRH). As a result of these efforts, and other factors, projections of the deficit have been put on a downward path. For example, CBO's updated analysis published in August shows its projected baseline deficit projections declining steadily from $224 billion in fiscal 1986 to $69 billion in fiscal 1991 (Table 1). The baseline projections assume that current spending and taxing policies remain unchanged over the period. The projections also assume real economic growth over the period averaging about 3.2 percent a year, slightly greater than the economy's long-run trend rate of growth, which pushes the unemployment rate down steadily to 6 percent in 1991.

Table 1. Federal Budget Deficit Projections (Fiscal Year, Billions of Dollars)

	Actual 1985	1986	1987	1988	1989	1990	1991
Baseline	212	224	184	150	127	96	69
Targets	NA	172	144	108	72	36	0
Baseline less Targets	NA	52	40	42	55	60	69
Structural Baseline	168	184	151	126	110	87	68

Source: Congressional Budget Office, August 1986

As shown in Table 1, the projected baseline deficits do not meet the GRH targets. If those targets are to be met, further fiscal policy action is required. The action may be taken under the so-called fallback provisions of GRH, through across-the-board spending cuts according to the law's formula. Or an alternative package of deficit reduction measures may be adopted. For fiscal 1987 alone, the official deficit estimate reported by the Office of Management and Budget (OMB) and the CBO was $163.4 billion. Because this estimate (an average of the two agencies' individual estimates) is greater than the trigger level for automatic spending cuts, Congress is required to move ahead with specific across-the-board reductions as defined in GRH, unless the target is otherwise achieved. Nearly $20 billion of such cuts would be necessary to reach the fiscal 1987 target for the deficit (Congressional Budget Office 1986b; Congressional Quarterly Weekly Report, pp. 1943–1946).

Some Questions about Balancing the Budget

Although there is widespread agreement about the desirability of federal deficit reduction, a number of questions may be raised about how deficit reduction is to be accomplished and about its potential economic effects. All the issues cannot be considered in this paper, which will address just a few of them.

As noted earlier, the large structural deficits of recent years were a source of substantial fiscal stimulus to the U.S. economy in its recovery and expansion after the 1981–1982 recession. It seems appropriate to consider, therefore, the potential effects of moving fiscal policy in the direction of greater restraint (or less stimulus). Here it is useful to turn to a structural deficit measure such as the standardized employment deficit. Changes in the structural deficit over time are generally used as an indicator of the short-run stimulating or restraining effect of fiscal policy on economic activity. If the fiscal 1987 GRH target is achieved, the structural deficit is estimated to fall by about 40 percent—a sharp movement in the direction of restraint on output growth. The CBO describes fiscal policy as becoming "quite restrictive" with the structural deficit estimated to decline from 4.3 percent of benchmark GNP in 1986 to 2.5 percent in 1987. According to the CBO, "This move would represent one of the largest annual shifts toward restraint in the past three decades," and meeting the GRH targets through fiscal 1991 would result in "the largest sustained amount of fiscal restraint in more than 30 years" (Congressional Budget Office 1986b, p. 34).

The restraining effect on economic activity of tightening fiscal policy over the full period would be expected to be offset by the beneficial effects of deficit reduction—namely, interest rates lower than they would otherwise be, better performance by the interest-sensitive investment sectors of the economy, and substantial improvement in the U.S. net exports position. Thus capital formation and economic growth would be favorably affected over the longer run. There is less agreement about the short-run effects, however. The significant degree of fiscal restraint possible for 1987 would occur in a very uncertain economic environment. Real economic growth has been modest so far in 1986, and prospects for significantly faster growth in the next 18 months are uncertain. Thus there are risks for the economy in the short run, especially if negative effects of fiscal restraint slow economic activity before the offsetting effects of deficit reduction on net exports and investment have their impact.

Agreement is widespread that very large and ever-growing structural deficits in a period of economic expansion can lead to serious problems for the economy. Agreement on precisely how to correct the situation is considerably less broad. Again, the questions are manifold and this paper will raise only a couple of them: What is the proper deficit target, and what are the options for deficit reduction.

What Is the Appropriate Deficit Target?

For a long time, it was implicitly agreed that the appropriate surplus or deficit position for the federal government was zero. The goal should be to balance the budget annually. Whatever else may be said about it, this goal is simple and easily understood; it has also been a generally popular goal. Even if achievable, however, an annually balanced budget is not the best goal for budget policy. The strongest reason for rejecting the goal of annual balance goes back to the notion of the cyclical deficit—that is, the budget deficit depends on the level of economic activity. Trying to achieve annual budget balance does not permit the budget to act as an automatic stabilizer for economic activity as it now does when, for example, the federal government puts more into the economy in recession than it takes out. Nor would discretionary fiscal policy actions be possible—deficits could not be used to stimulate the economy nor surpluses to restrain it.

Another possible goal of budget policy is to balance the budget, on average, across the business cycle. Such a goal would permit the automatic stabilizers to work, but deficits incurred to reduce the severity of recessions would have to be offset by surpluses achieved during business cycle expansions (Congressional Budget Office 1984, p. 74; de Leeuw and Holloway).

A third possible goal is to balance some measure of the structural deficit (Congressional Budget Office, pp. 73–76). For example, the goal might be to balance the standardized employment budget. With such a goal, a deficit would exist as long as economic activity was at a level associated with an unemployment rate above the chosen benchmark rate.

Many alternative guidelines for fiscal policy exist. Several are expressed as deficit goals, often in terms of cyclically adjusted deficits. The GRH deficit targets have been criticized because they are expressed in terms of actual deficits with zero deficit, or actual budget balance, as the goal. Thus the GRH targets do not take into account the state of the economy and how it affects the deficit. While there are escape mechanisms in GRH for periods of recession or very slow growth, the use of actual deficits as targets creates the potential for counterproductive fiscal actions in periods of weak economic activity. It has been argued that expressing the GRH goals in terms of structural deficits would greatly improve their usefulness as a guideline for fiscal policy (Blinder, pp. 470–474).

What Are the Options for Deficit Reduction?

Table 1 shows that, assuming steady and relatively strong economic growth over the period, the deficit is projected to decline steadily to 1991—on the assumption of no real growth in either defense or nondefense appropriations and with no change in current spending and taxing programs. But budget balance is not achieved, in either actual or structural terms. Achievement of budget balance, then, requires further action.

In the broadest possible sense, it is easy to state the options: Cut spending, raise taxes, or do some of both. Choosing among these options, especially in terms of specific programs and taxes, is obviously not so easy. Professor Alan Blinder of Princeton has offered a suggestion on how to make the choice.

> The choice between tax hikes and spending reductions is political, in the best sense of word: Does the citizenry want the programs enough to pay taxes to support them? If so, we should raise taxes. If not, we should cut the programs (Blinder, pp. 474–475).

Again, the implementation of choices based on this guideline would not be easy but the guideline appears to be a sensible one.

This guideline also suggests an issue that is related to, but not the same as, the issue of deficit reduction. That issue revolves around the question of what is the appropriate size of the federal government—how big should the federal sector be in terms of its share of the nation's output or resources? That question relates to the size of federal spending, not directly to the question of budget balance. Those who frame the issue of deficit reduction solely in terms of spending reductions seem to be motivated at least partly by a desire for a reduction in the size of the federal sector. Blinder's guideline suggests a somewhat different approach.

Many combinations of program changes and revenue increases are possible to bring about deficit reduction. Each year the CBO produces a large volume, entitled *Reducing the Deficit: Spending and Revenue Options,* which includes dozens of specific policy options with dollar budgetary savings identified for each (Congressional Budget Office 1986c). For such important quantitative detail, that volume should be consulted. This paper will conclude with two general comments, one on spending and one on taxes.

Perhaps the most important general point to make about federal spending (and thus about spending reduction) is that a very large part of federal outlays is found in only a few budget categories. National defense, net interest payments, and entitlement programs accounted for more than 85 percent of federal outlays in fiscal 1985 (Table 2). Interest payments must be made and are thus excluded from deficit reduction programs. If defense spending and major entitlement programs (Social Security and Medicare accounted for just under 60 percent of entitlement outlays in fiscal 1985) are not involved in deficit reduction, substantial total spending cuts will be hard to come by.

Table 2. Budget Outlays for Major Spending Categories (Fiscal Year 1985)

Category	Billions of Dollars
National Defense	252.7
Entitlements	440.2
Net Interest	129.4
Nondefense Discretionary Spending	172.1
Offsetting Receipts	–48.1
Total Outlays	946.3

Source: Congressional Budget Office, February 1986.

The revenue side also poses hard decisions. After a long and difficult process, a tax reform bill seems about to become law. Because tax reform has just reduced the rates and broadened the bases of both individual and business income taxes, it seems unlikely that those sources would soon be used to increase revenues for deficit reduction.

Remaining options are to increase other existing taxes or to turn to a new tax. Among existing taxes, excise taxes on cigarettes and alcoholic beverages might be good candidates for increases. Increases bringing those tax rates back into line with historical rates would provide a significant amount of revenue in the neighborhood of $12 billion a year (Congressional Budget Office 1986c, pp. 237–240).

Broad-based taxes are generally considered preferable to narrow-based taxes such as the excise taxes on tobacco and alcohol. A new broad-based tax being discussed as a means towards deficit reduction is the value-added tax (VAT). The VAT is an indirect consumption tax, collected at all stages of production. Except for the method of administration, it is essentially like a retail sales tax. Even after adjusting its base to reduce its regressivity, the VAT is potentially a powerful revenue provider. A VAT is likely to receive much attention if revenue increases are seriously considered as a means towards deficit reduction (Miller).

Conclusion

This review of some of the issues surrounding the goal of federal budget deficit reduction suggests that achieving the goal will require fiscal policymakers to make difficult political decisions that will have significant economic consequences. Now that tax reform appears to have been achieved, budget deficit reduction is at the top of the fiscal policy agenda.

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