Fiscal Stimulus in the Current Recovery

In view of the recent budget measures passed by the U S Congress, will the reduced, but nevertheless still large, federal budget deficits continue to have a stimulative effect on the economy? Our analysis suggests that unusually strong fiscal thrust should persist through 1984 and 1985, even with the recent "downpayment" package included in the Deficit Reduction Act of 1984 [1]

In its latest forecast, the Congressional Budget Office estimated that prior to the Deficit Reduction Act, the federal deficit would have been around $195 billion in 1985. This would represent about 5 0 percent of GNP, down from a peak of 6.1 percent in 1983. With the $13 billion downpayment package, though, the deficit should fall to roughly 4.6 percent of GNP in 1985 And, if Congress cuts defense spending, the ratio could be even lower

On the surface, this may seem to indicate that the stimulatory effect of fiscal policy will decline from 1983 to 1985 In measuring fiscal stimulus, however, it is important to separate business cycle effects from discretionary policy For example, the federal deficit usually falls during an economic upturn whether or not new policies are enacted, as higher growth brings about an increase in federal tax receipts and a drop in unemployment benefits. For this reason, we focus on the ratio of the high-employment deficit to potential GNP.[2]

[1]The Deficit Reduction Act of 1984 includes nearly $11 billion in higher revenues and about $2 billion in lower nondefense outlays in fiscal 1985 It does not include reductions in defense outlays

The Effect of Federal Policy Changes Since 1981 on Budget Deficits*

In billions of dollars, by fiscal year

Legislative changes	1982	1983	1984	1985
Tax reductions†	−40	−73	−93	−106
Defense spending increases	−1	−17	−25	−36
Nondefense spending cuts	39	46	48	61
Effect of legislative actions on interest costs	‡	−2	−9	−18
Total changes	−2	−47	−79	−99

*The figures for 1982-84 are Congressional Budget Office (CBO) estimates The 1985 figures are CBO estimates adjusted by the authors to include the revenue and outlay provisions contained in the Deficit Reduction Act of 1984 A negative figure indicates that the legislative change contributed to the federal budget deficit The aggregate changes are in net terms and are the difference from the CBO baseline in each year

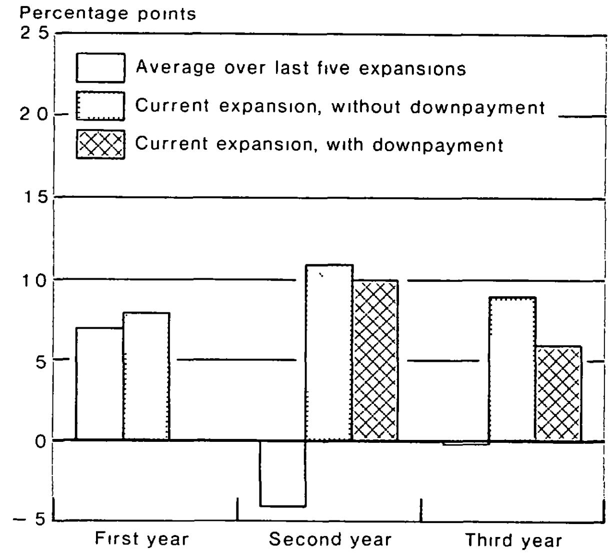
†The effects of changes in social security tax rates and maximum taxable income legislated prior to the 1983 Social Security Amendments are not included

‡Less than $500 million

Source *Baseline Budget Projections for Fiscal Years 1985-1989*, Congressional Budget Office (February 1984)

Change in the Ratio of the High-employment Deficit to Potential GNP in Expansion

Percentage point change in yearly average



A positive number indicates an increase in the ratio of the high-employment deficit to potential GNP, a negative number indicates a decrease

The high-employment deficit and potential GNP estimates for 1984 and 1985 were calculated by the authors in two steps First, adjustments were made to the Bureau of Economic Analysis' (BEA) estimates for different assumptions regarding interest rates, potential GNP, and profit and income shares Second, the proposed spending and tax changes in the Administration's Fiscal Year 1985 Budget, embodied in the BEA's estimates, were omitted in the "without downpayment" scenario and were replaced with the revenue and outlay provisions in the Deficit Reduction Act of 1984 in the "with downpayment" scenario

Sources The high-employment deficit and potential GNP estimates through 1983 are calculated by the BEA For recent estimates, see Joseph C Wakefield and Richard C Ziemer, "Federal Fiscal Programs", Survey of Current Business (February 1984), pages 9-19

[2]The high-employment deficit is calculated under the assumption that the economy is at full employment, which, in recent years, is defined as 6 percent unemployment This measure is derived by adjusting many components of outlays and receipts, e g , unemployment insurance benefits and individual and corporate income taxes, to reflect the impacts of differences between actual and potential levels of economic activity

The high-employment deficit as a share of potential GNP rose from 0.6 percent in 1981-I to 3.3 percent in 1984-I. Even with the downpayment, it will average 4.4 percent in 1985. Legislative changes since 1981 are mostly responsible for the increasing high-employment deficit. In particular, the 1981 tax cut package, the growth of defense outlays, and the indexing of the individual income tax in 1985 contribute substantially to the increase (table).

As a result, fiscal thrust in this expansion is quite large compared with that in past economic upturns. To be sure, the nearly one percentage point rise in the high-employment deficit to potential GNP ratio in 1983 is similar to what generally occurred in the first year of earlier recoveries (chart). But the consecutive increases in 1984 and 1985 contrast markedly with the typical declining or neutral pattern over the second and third years of expansion. The current stance of fiscal policy, then, may be an important factor behind the unusually strong growth in real GNP so far in 1984. Our results also indicate that next year's economic activity should still be buoyed by the impetus of fiscal policy.

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