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Keskusteluaiheita
Discussion papers

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US BUDGET DEFICIT:

Some background information*)

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1. INTRODUCTION

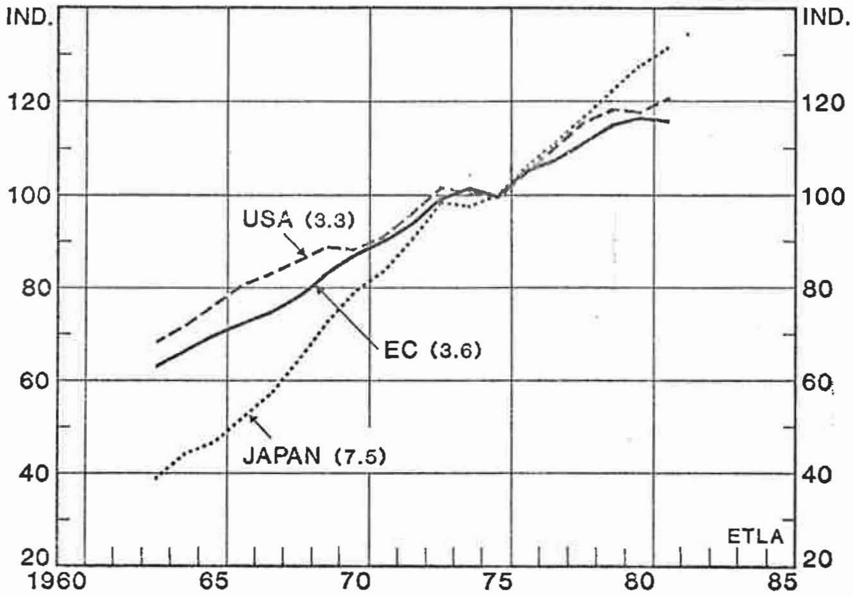
The purpose of this paper is to describe the key points of the Reagan Administration's economic policy and its domestic macroeconomic effects, the chronic budget deficit and its national implications, and the global influence induced by the US economy. First, it is important to illustrate the significance of studying the United States as a dominant economy in the world picture.

Since the end of World War II, the role of the US has changed from one of a leader in the world economy toward one of an interdependent power among other nations. While the impact of US economy on other countries has decreased, the economies of Europe, Japan and the Middle East have become increasingly important. For example, Japan's average growth rate from 1960 to 1981 was 7.5 %, while that of the US was 3.3 %. However, the share of US GDP as a percentage of OECD GDP still remains large in comparison to that of Japan (see Figure 1.1). Despite this changed role, the domestic and international health of the United States still remain key factors in the world economy. In 1981, the US accounted for 25 % of the world's production, and 34 % of the GDP of OECD countries, The USSR, ranking second in world output produced 12 % of world GDP, while Japan, ranking second among OECD countries, produced 10 %.

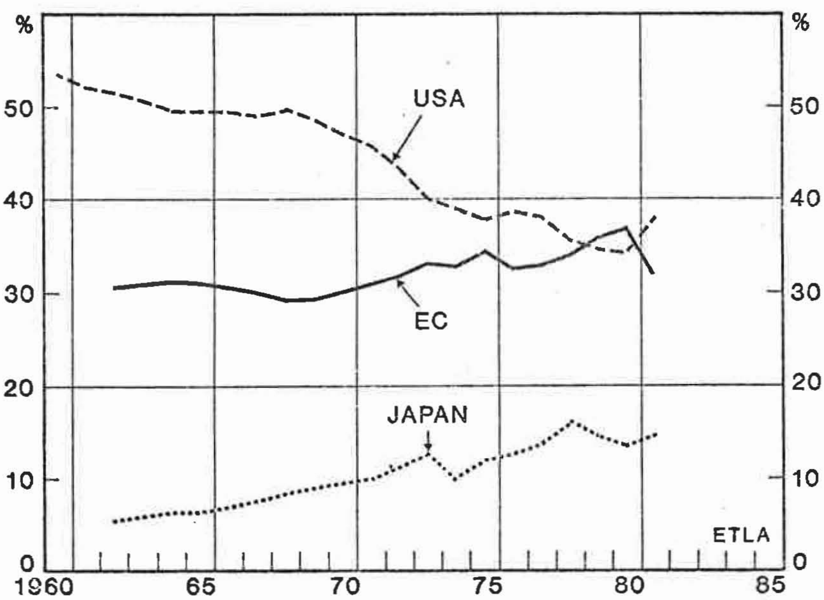
International trade and investment has been one of the most dynamic elements in world growth for the past several decades. In the goods sector the US comprises 10.8 % of total OECD imports and 11.6 % of total OECD exports (1982), while Germany ranking second, accounts for 10.2 % of the imports and 9.0 %

Figur 1.1. Indicators of GDP growth

a. GDP volume indices (1975 = 100)



b. US, EC, Japan GDP's as a % of OECD GDP (at current prices and exchange rates)



Source: OECD National Accounts 1951-1980.

Note: Numbers in parentheses indicate average growth 1960-1981.

of the exports. Since 1971, however, the US has run a trade deficit of goods in all but two years. Of course, cyclical factors may contribute to the deficit, as well as abnormally high values of the dollar since 1981, which have further exacerbated the deteriorating US competitive position. It should be noted that though the balance in goods has frequently been in deficit, the balance in services has more often been in surplus.

A large part of growth in the post-war US economy has been reflected in services, with the growth in this sector becoming increasingly important. In 1981, 66 % of US economic output was in the services sector compared to 54. % for Japan and 51 % for the OECD average. foreign trade the services sector is not as large as the goods sector, although it is growing rapidly despite trade obstacles that may exist.

From this economic picture, it is clear to see that the US economy and their policy decisions affect the world economy. Domestic problems of the US - stagflation, high interest rates, unemployment - are linked to international economies. Economic welfare abroad depends on the US, and domestic recovery in the US depends on a revival in the world economy. Even of greater importance in this role of interdependency is the growing financial relationship among countries. For example, interest rates in the US affect both domestic and international markets.
As well as perpetuating the "crowding out" effect of private investment, the high interest rates induce capital outflows from other countries, inflating world interest rates and thereby restricting growth. Also stemming from high interest rates is revaluation of the US dollar, decreased price competitiveness of the US economy, and increased competitive position of Europe, Japan and others (however, combined with some inflationary pressure).

High interest rates and the increasing value of the dollar can exacerbate the world debt problem, as many developing countries hold debt which is nominated in US dollars. As US interest rates or the value of the dollar increases, the burden of paying not only upcoming obligations, but debts which have been postponed from prior rescheduling becomes greater.[1)] Variations in exchange rates also impose problems for traders. If importers or exporters invoice their merchandise in a foreign currency, their net income is subject to fluctuations of that currency's exchange rate, (if all risk is not diversified away).

An important factor which contributes to the high interest rates in the US is the persistent federal deficit. There are numerous explanations for such a nagging budget problem, and these will be taken up in the third chapter. Chapter two briefly describes past and present domestic policy and trends of the US economy. Chapter three devotes special consideration to the US Federal deficit and its implications on interest rates, investment and productivity in the US. The appendix contains descriptions of the institutional aspects of US budgetary procedure, and the Federal Reserve System.

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1) It is interesting to know that the US has been scaling down loans for sales of arms to countries with shake financial status - such as Morocco, Somalia, Sudan, Tunisia, Zaire, Israel - and has instead been giving outright grants for the procurement of arms.

2. THE REAGAN ADMINISTRATION

From the end of the recovery in 1979 to the beginning of 1983, the US economy had been characterized by a weakening real economy, fluctuating and generally high interest rates, an appreciating dollar, an easing of inflation, and rising unemployment. These conditions continued through 1981, and by the beginning of 1982, the second recession in two years hit, causing unemployment to soar and output to decline.

Reagan's New Program for economic recovery in 1981 could not have expected to bring immediate changes in economic performance, however it did bring US economic policy into a new light. With the challenging goal of simultaneously bringing about a reduction in inflation, and an increase in economic growth, the Administration took a more conservative stand than there has been in US economic policy since World War II.

The New Program for economic recovery

In his first major address to the Congress in February 1981, President Reagan proposed a national recovery plan to reverse the chronic condition of persistent inflation and economic distress, and to create conditions that would provide an atmosphere for faster economic growth. The key elements of his plan included :

1) A budget reform plan to cut the rate of growth in federal spending in an attempt to reduce the deficit.
2) A reduction in personal income tax of 10 % per year over three years, and an accelerated form of depreciation as an incentive to greater investment in production and job creation.

3) A reduction in federal regulations which impose costs to business and consumers and create barriers to investment, employment, and production.
4) A commitment to a monetary policy that will restore a stable currency and healthy financial markets.

Fiscal Policy Issues

The budget presented to Congress in 1981 projected a significant reduction in the federal deficit, with the goal of a balanced budget by 1984. This was to be accomplished through a reduction of social programs and elimination of non-essential or ineffective federal programs.[1] The 1982 budget proposal reaffirmed the Administration's commitment set in the New Program, and emphasized their intention to deal with the deficit over time through stringent spending control rather than by major increases in taxation. But by 1983, the Administration realized that despite proposed budget outlay reductions, the federal deficit would continue to remain large for some time and there would be no chance of a balanced budget by 1984. Although roughly two thirds of the 1983 deficit appeared to be the result of economic slack[2], the sharp rise in part is due to more expansive than proposed budget policies - particularly the increase in entitlement programs and defense spending - as well as recent tax cuts.

The budget for FY 1984 was introduced 1983 amidst large and rising projected current services deficits. Key elements of the budget include:

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1) Social programs include food stamp coverage, extended unemployment benefits, trade adjustment assistance, student loans, various social security benefits, medicaid, and other entitlement programs. Federal programs include CETA (Comprehensive Employment and Training Act), Amtrack, energy research and development programs, impact aid, and support for the arts.

2) The Outlook for Economic Recovery, Feb. 1983, CBD. Current services are budget authority and outlays for the ensuing fiscal year based on continuation of existing levels of service. This figure may be questionable: Morgan Guaranty, trust company estimates that roughly one half of the 1983 budget deficit was structural.

1. A freeze on public sector pay, on cost-of-living adjustments, on aggregate discretionary spending, and various reimbursement formulas[1)] and payments.
2. Reform of entitlements and transfer payments focused on health care, social security solvency, federal retirement programs, and means-tested benefits.
3. Standby revenue powers to be activated if the federal deficit were still running above 2 1/2 % of GNP in 1986.
4. Maintenance of the defense buildup.

The budget proposals also noted the change in the balance of fiscal influences on the economy from that which was proposed in the 1981 program: Congressional budget action has fallen short of goals for non-defense expenditure reductions, and has substituted some tax increases.[2)]

The Economic Recovery Tax Act of 1981 was part of the New Program which was designed to create a climate for long-run economic growth. The intent was to increase investment demand through an increase in the rate of return to the personal sector on investment in productive capital. The Administration proposed three successive annual cuts of ten per cent in personal income tax rates, beginning in July 1981. The program also included increased depreciation write offs against business taxes, a

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1) Reimbursements are sums received by the Federal Government as a repayment for commodities sold or services furnished either to the public, or to another Government account that are authorized by law to be credited directly to certain appropriation and fund accounts.

2) OECD Economic Outlook 1983.

reduction of the oil windfall profits tax, the taxation of married couples and of American's employed abroad, increased personal tax exemptions for certain types of saving.[1)]

In recent years, economists and other tax experts have shown support for moving the US tax system toward consumption tax and away from the taxation of income on the basis that taxing individuals on what they take from the economy is "more equitable" than taxing what they contribute to the economy.

Monetary Policy Issues

From World War II until the mid-seventies, the Federal Reserve conducted monetary policy by focusing on interest rates and money market conditions. The Fed began to put more emphasis on targeting monetary aggregates instead of following interest rates during the seventies. In 1979, they advocated the practice of following prespecified money targets as their main counter inflation weapon. The Administration also indicated that in an inflationary economy, their fundamental principle of monetary policy should be a gradual reduction in the rate of growth of the money stock until the rate is consistent with price stability. Since this change in policy, interest rates have been more volatile and periodically higher than historically speaking, thus suggesting that the Fed was willing to allow interest rates to fluctuate more than in the past. As can be seen from Figure 2.1 (page 9), real interest rates increased sharply since the late 1970's and fluctuated throughout the early 1980's, while still maintaining an upward trend.

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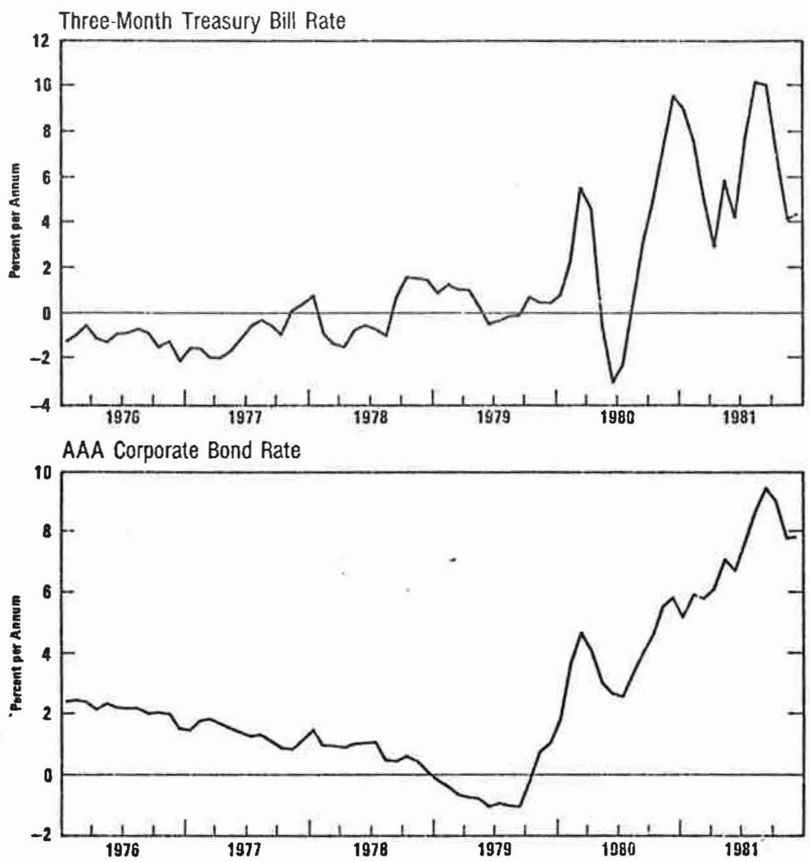
1) For more detailed information, see "America's New Beginning, A Program for Economic Recovery", The President's address to the nation, February 18, 1981.

Figure 2.1. Estimates of Real Interest Rates

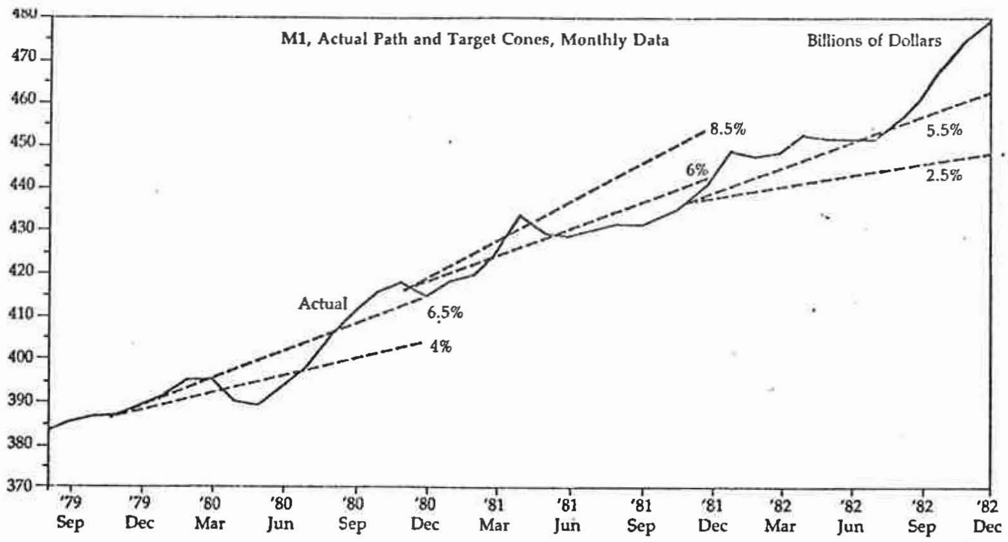


Source: Congressional Budget Office.

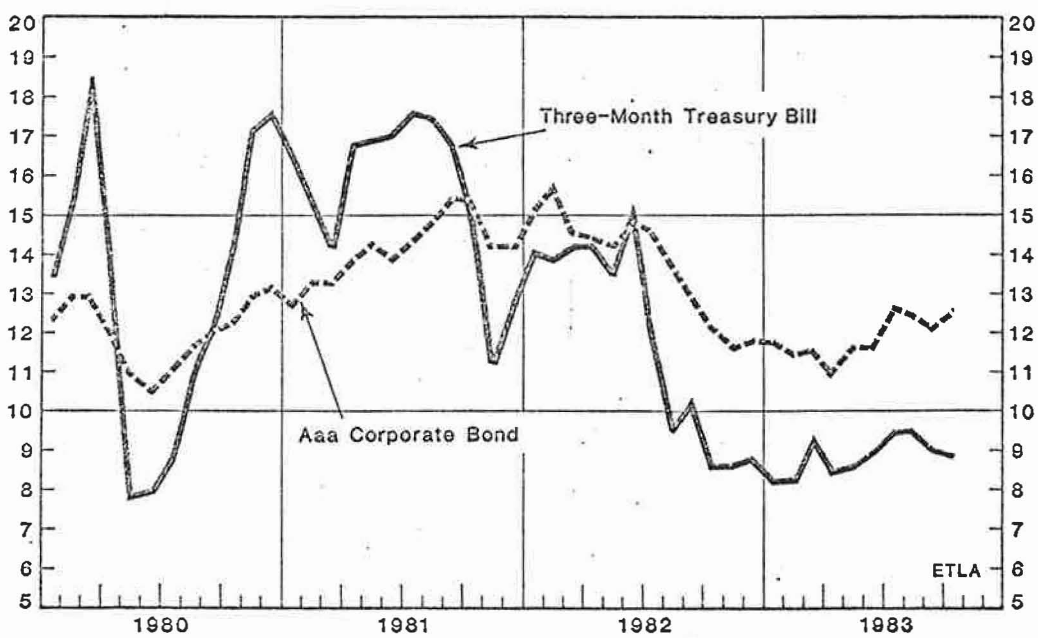
Note: The real rate of interest is the nominal rate of cover the previous three month period for the T-Bill rate) minus the expected rate of inflation which is the CBO projection. Reprinted from The Prospects for Economics Recovery, February 1982, CBO.

The growth of money aggregates and the behavior of interest rates, notably short-term rates, are economic variables which are closely watched as indicators of monetary policy. There is much debate over the fact that the Fed has not kept the money stock smoothly on its target path. As we can see from Figure 2.2a the M1 aggregate has fluctuated around the prespecified target "cones" since the beginning of 1980. Many economists

Figure 2.2. a. M1, Actual Path and Target Cones, Monthly Data



b. Nominal interest rates



Source: a. Reprinted from the Brookings Review, Spring 1983.
b. Morgan Guaranty Trust.

contend that the erratic pattern of money growth over the past few years has contributed to volatile and high interest rates in the US (Figure 2.2b, page 10). However, it is important to keep in mind that there may be other non-policy factors which can influence nominal or real interest rates.

In late 1982, new institutional developments were introduced which led to some confusion regarding the interpretation of money aggregates. The new "Super-Now" accounts (interest bearing deposit) and money market deposit accounts (MMDAs) had an impact on the mix of time and savings deposits, thus changing the meaning of the aggregates. Since these developments, the Federal Reserve Board has been following less closely the money supply data, especially that of the narrowly defined M1 aggregate, and watching instead broader measures as well as interest rates. The 1983 prespecified target ranges for M1 are 4 % - 8 %, somewhat higher than the 1982 target of 2 1/2 % - 5 1/2 % and suggest the policy shift toward keeping a closer watch on interest rates.[1)]

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1) OECD Economic Outlook, July 1983.

3. THE UNITED STATES FEDERAL BUDGET DEFICIT

Past and present deficits

The United States budget has been in surplus only once in the past 20 years. In a Keynesian light, it may be argued that during periods of recession, a rising budget deficit may serve to limit both the magnitude and duration of a slowdown in economic activity. Of course, if the rise in the federal deficit were principally due to cyclical phenomena, there would be little cause for concern: a recession necessitates an increase in outlays for unemployment benefits, retirement benefits, and other activities, thus creating an excess of expenditures over receipts. The 1982-1983 fiscal year budget deficit is partially a result of the recession, but the persistent large and growing budget deficits are neither principally nor exclusively due to cyclical phenomena. Without legislation proposed by the Administration for its 1984-1988 FY budget plans, the US is forecasted to experience deficits that account for up to 4.4 % of GDP.[1)] (see Figure 3.1 page 13). US government publications forecast federal deficits that would consume up to 6 % of GNP in the next six years,[2)] based on optimistic assumptions of GNP growth of 4.4 %.

The trend of federal government spending has changed away from purchases of goods and services, and toward increased transfer payments (see Chart 3.1 page 14). Total federal government spending as a proportion of GNP remains high compared to historical standards, due to the buildup in defense spending, rising interest payments, and growth in entitlement programs, while tax revenues

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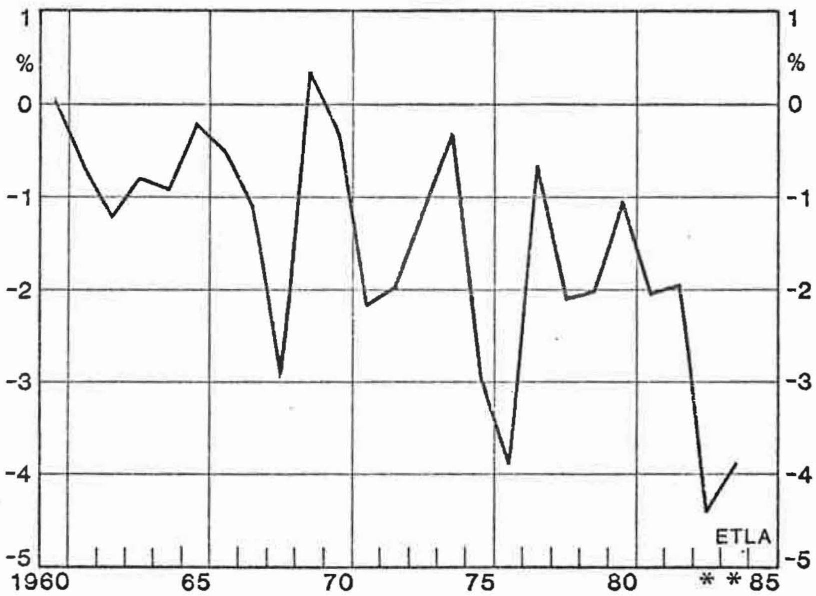
1) OECD Economic Outlook, July 1983.

2) Economic Report of the President, Transmitted to the Congress February 1983.

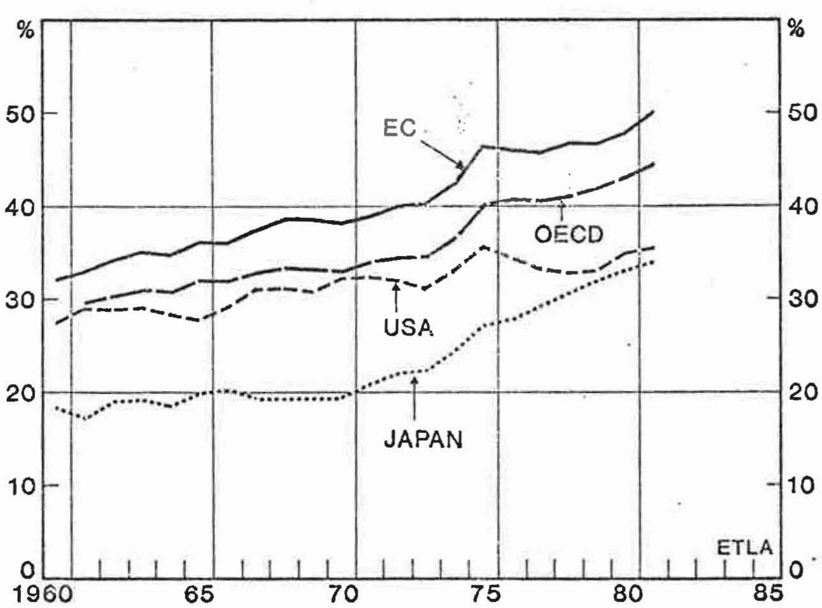
Figure 3.1. US budget deficits as a % of GDP



Source: OECD National Accounts, Budget of the US Government, FY 1983.
Note: 1983 and 1984 are OECD estimates.

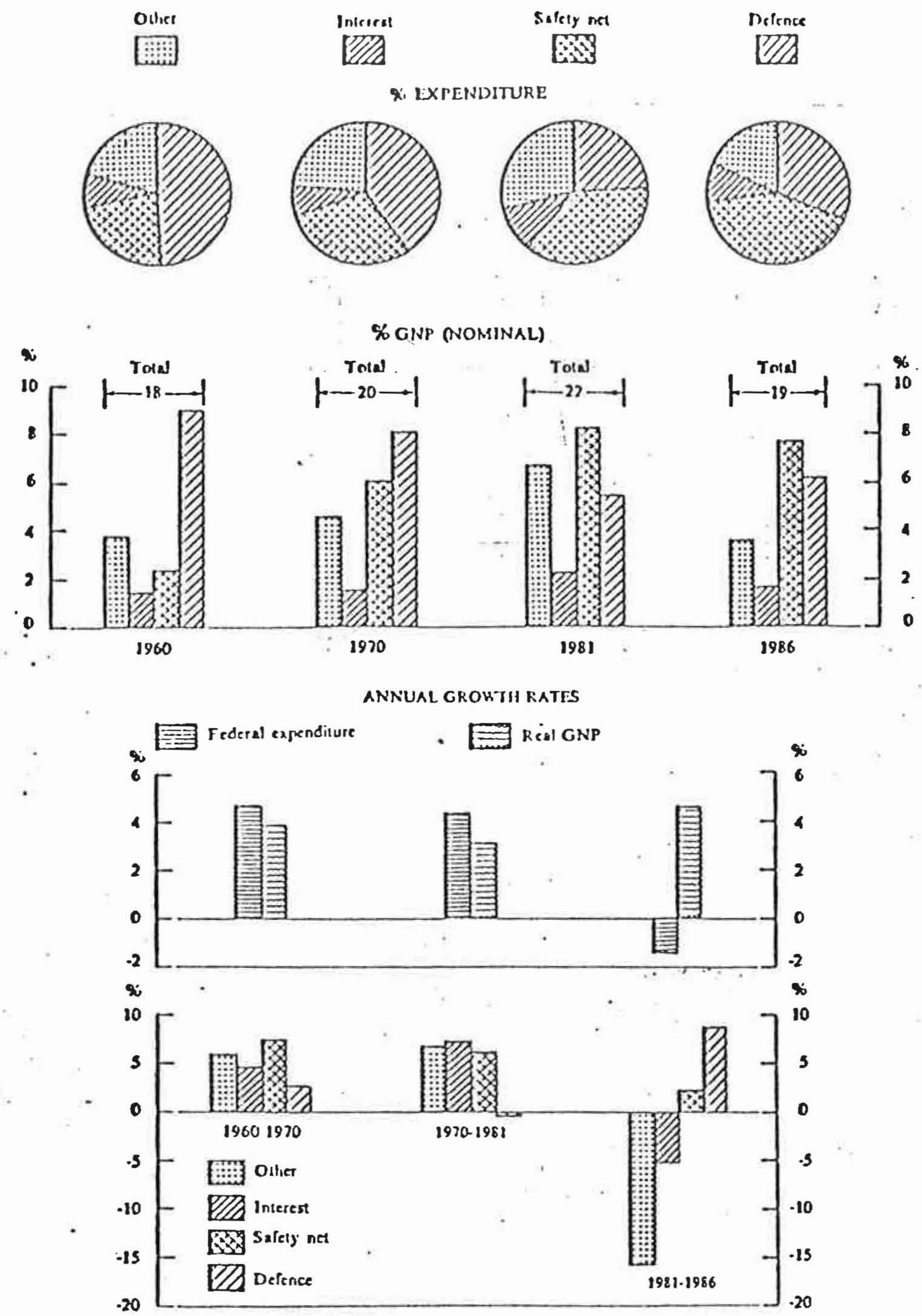
have declined due to the Economic Recovery Tax Act of 1981. On the other hand, US federal government expenditures remain lower than the average for both EC and other OECD countries, as can be seen from figure 3.2.

Figure 3.2. Total Government Expenditures as a % of GDP



Source: OECD Historical Statistics, 1960-1981.

Chart 3.1. Federal expenditure Trends



Reprinted from OECD Economic Surveys, 1981-1982.

Financing of the deficit

Prospective deficits may be financed through increased taxation, or by borrowing. The present Administration, however, prefers to deal with the budget deficit by means of stringent spending control rather than through increases in the tax burden.

Government accounts at the Federal Reserve System are held and operated by the Treasury. The Treasury is the agency of the Federal Government that collects government receipts and makes payments for them. If the Treasury wishes to borrow, it may do so directly from the central bank, or from the private sector. When the Treasury borrows from the private sector, it sells Treasury securities or debt to them (including financial institutions and foreign central banks). The checks from the private sector are received and spent by the Treasury in the same way as tax receipts are, hence the supply of money remains unchanged except for a brief time lag. When the Treasury borrows from the central bank, the Fed "monetizes the debt" by giving the Treasury a check on the central bank, which in effect increases the money supply.[1)]

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1) It should be emphasized that the central bank, or Fed remains independent, in most respects, from the Government. The Fed does not actually buy debt directly from the Treasury, but rather does so indirectly by buying securities (open market purchases) from the public. The net effect of the combined Treasury sale of debt and Fed open market purchases is that the Fed ends up holding more Treasury debt: the same as if they had bought directly from the Treasury.

Domestic economic impacts

Proposals to reduce the federal deficit of 1983-84 are opposed by some economists who argue that to do so may slow the economic recovery. But running persistent deficits over a prolonged period could seriously impact the overall performance of the US economy. Because the relationship between budget deficits and other economic variables is not clearly defined, care must be taken in drawing conclusions from two-variable analyses of the short-run effects of federal budget deficits.

The adverse economic consequences of federal deficits depend to a large extent on how they are financed, whether through borrowing, or by an increase in taxation. Since the 1960's, federal government borrowing has been associated with periods of relatively low interest rates; generally, the demand for credit decreases in what one would assume to be a recessionary period, or one in which deficits become greater. Now however, federal government borrowing to finance a non-cyclical budget deficit is associated with periods of rising interest rates: increased competition for funds in periods of recovery results in higher interest rates, and may cause "crowding out" of private investment. This results in a reduction in the rate of capital formation, and depresses the level of output in various economic sectors such as construction agencies, the steel industry, machinery and equipment industries, and industries producing other consumer durables.

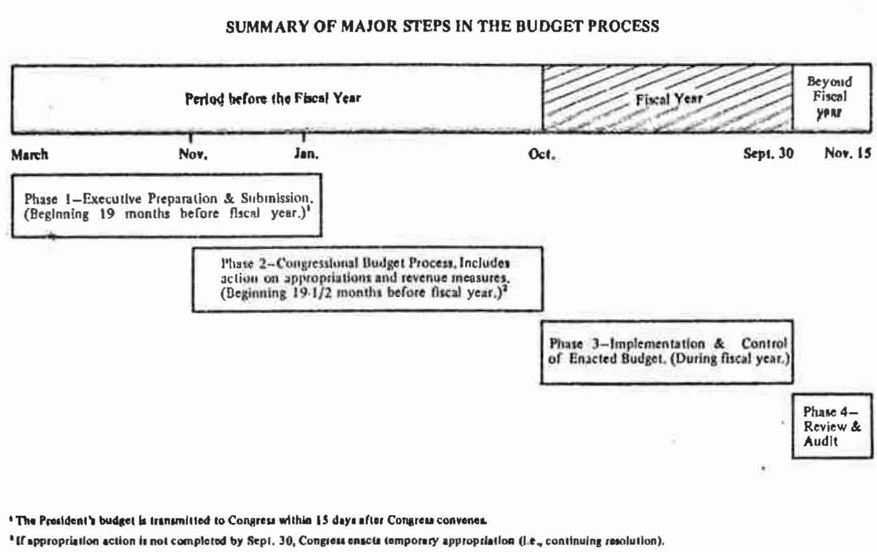
Increased government borrowing exacerbates inflationary pressures if the Federal Reserve is induced to expand the money supply to limit the rise in interest rates. However as we may recall from chapter 2, during the late 1970's until 1982 the Fed was more concerned with reducing the money growth instead of controlling interest rates. The Fed, and even more so, the Reagan Administration encouraged the idea that the most effective way to reduce inflation and keep it under control was through strict adherence to "money targets". The impact of a change in taxation on the economy is mostly through its affects on aggregate spending. Spending by consumers, businesses, and government influences output, employment, and prices, and the federal government can effect changes in aggregate spending through its taxing and spending policies. However, it is difficult to determine the adverse impacts of a change in the tax burden on the economy. For example, a budget deficit induced by a reduction in revenue due to lowered taxes may be partially or totally offset by the tax incentives for investors.

Appendix 1.

THE US BUDGETARY PROCESS[1)]

Under the Budget and Accounting Act of 1971, every year the President must transmit a proposed Federal budget to Congress within 15 days after it convenes in the new calendar year. The budget message contains the proposed budget for the fiscal year that runs from October 1 through September 30. Under the executive budget process, agency officials channel their budget requests through the cabinet level, and in turn through the Office of Management and Budget (OMB), which reviews the requests in light of the President's proposed budget initiatives. The budget is formulated in the scope of a multi-year planning and tracking system which extends coverage four years past the fiscal year, and integrates long-run planning into the program.

Summary of major steps in the Budget making Process



Source: Budget Glossary of the US General Accounting Office.

1) For further information concerning the budget making process, see the Budget Glossary of the US Government, or Budget of the US Government FY 1983.

The budget process consists of four phases:

Phase 1: Executive Preparation and Submission

Preparation of the budget begins in the spring prior to its submission. It originates at the agency level where individual organizational units review current operations, program objectives, and future plans in light of the upcoming budget. During this process, there is a continuous exchange of information between the various Federal agencies, the OMB, and the President. Agency officials are guided by revenue estimates and economic outlook projections from the Treasury Department, the Council of Economic Advisors, the Department of Commerce and Labor, and the OMB.

In the Fall and early winter of the preceding fiscal year, the executive branch[1] is developing the President's budget. They make detailed reviews of agency's requests, then determine the budget for each which may later be revised. The President then transmits the budget proposal to Congress by January 15.

Phase 2: The Congressional Budget Process

The "Budget of the United States Government published each January, by the Congressional Budget Office (CBO), contains the President's proposals for the Federal Government's outlays and budget authority for the upcoming fiscal year. Congress may act to approve, modify, or disapprove of the proposals. For example, it can change funding levels, eliminate proposals, or add programs. It can also enact legislation affecting taxes and other sources of receipts. Congress does

1) Executive Agency generally means any executive branch department, independent commission, board, bureau, office or other establishment of the Federal Government, including independent regulatory commissions and boards.

not determine the level of spending for individual programs, rather it provides budget authority to a specific agency.[1)]

The first budget resolution begins March 15, and authorization and appropriations committee reports to the House and Senate Budget Committees on budget estimates. On the first of April, the CBO submits its report detailing alternative spending patterns and revenue levels associated with different budget options. The CBO report, which in theory is used in drafting the first budget resolutions, gives Congress upper and lower limits in relation to the President's estimates. On April 15, the Budget Committees of both Houses report the first concurrent budget resolution to Congress, which establishes targets for a) the appropriate level of total outlays and total new budget authority, both in aggregate and by functional category, b) the appropriate budget surplus or deficit, c) the recommended level of Federal revenues, d) the appropriate level of Federal debt. The first budget resolution is scheduled to be passed by May 15, and until it has been finalized, neither House can consider any spending or revenue measures that would take effect in that fiscal year. The revenue bills are then transmitted to the President as an enrolled bill for his approral or veto.

After action is taken on all money bills, Congress adopts a second budget resolution which specifies the budget ceiling for <u>total</u> budget authority and outlays, and a floor on budget receipts. This resolution must be made final by September 15. Once the second resolution is in place, no legislation can be passed that would breach these limits, unless Congress passes a subsequent resolution.

1) Some agencies are given permanent budget authority under which funds become available annually without Congressional action; some agencies are authorized for a specific number of years; other agencies, such as nuclear energy, space exploration, defense procurement, and foreign affairs require annual authorizing legislation.

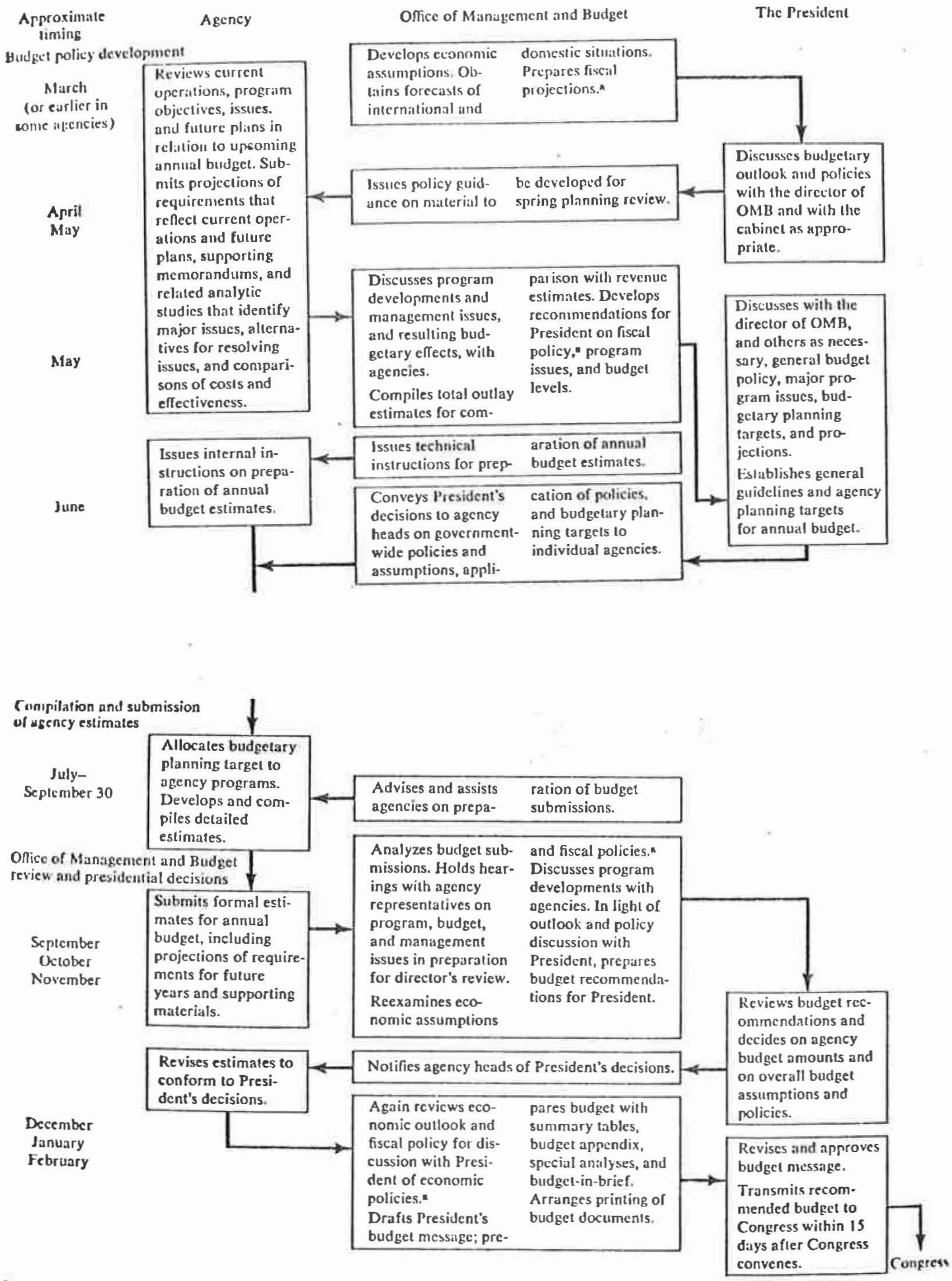
Phase 3: Implementation and control

Once approved, the President's budget becomes the basis for financial planning for the operations of individual agencies. The Director of OMB distributes appropriations and other budgetary resources to each agency by time periods, or by activities. If more appropriations are needed during the year, additional requests may be sent to Congress, or reserves may be established under the Antideficiency Act to provide for contingencies. On the other hand, the Impoundment Act of 1974 allows for appropriations to be withheld from obligation for policy or other reasons. However, the executive branch must report to Congress any deferrals or rescissions of budget activity.

Phase 4: Review and Audit

Individual agencies must insure that the obligations and outlays they incur follow the provisions which are set up by the budget process. Agencies are assised in this function by an audit staff. Also, the General Accounting Office (GAO) regularly audits and evaluates government programs.

Figure 3-1. Formulation of the President's Budget



Source: Office of Management and Budget.
a. In cooperation with the Treasury Department and the Council of Economic Advisers.

Appendix 2.

THE FEDERAL RESERVE SYSTEM

The Federal Reserve System (FRS) created in 1913, is the central bank of the United States. The power and authority of the FRS derive from Congress, and can be taken away or modified. Legislation to create the FRS was designed to isolate them from short-term political pressure, thus giving them a large degree of independence from the Federal Government. However, this independence is qualified in the respect that the FRS must interact with both the Administration and Congress in determining monetary policy.

The FRS is operationally divided into 12 districts, located in major financial regions of the country, each having its own Federal Reserve bank. There are two policymaking bodies of the FRS. The first body, the Board of Governors in Washington, has full control over the 12 district banks and their 25 branches. The Board consists of 7 members who are nominated by the President and approved by the Senate. Members of the Board serve 14 year terms and may not be reappointed in consecutive terms. The Chairman of the Federal Reserve Board is appointed by the President and approved by the senate, and may serve consecutive 4 year terms.[1)] Presently, Paul Volcker is in his second term as Chairman of the FRB. The second body is the Federal Open Market Committee (FOMC) which is the system's chief monetary policymaking body. The FOMC consists of the Board of Directors, and 5 of the 12 presidents of the Federal Reserve banks

1) The 4-year term of the Chairman does not have to correspond to the Presidential term, and so the Chairman may not necessarily change with the election of a new President. Proposals have been made recently to allow a new President to reappoint new chairman.

who rotate on a yearly basis.[1] The committee generally meets once every 4 to 6 weeks to set Federal Reserve guidlines regarding open market purchases and sales of government securities.

The FRS performs functions for the Federal Government which aid in the financial activities of the market. It clears checks written on one depository institution but deposited in another part of the country; it places currency and coin minted by the Treasury into circulation; and it handles the US Treasury's financing operations. For implementing monetary policy, the FRS has the following power: to set reserve requirements for all depository institutions with certain types of deposits; to set the discount rate, or the rate of interest at which member banks borrow (usually overnight) from the Federal Reserve banks;[2] to regulate member banks and bank holding companies;[3] and to perform open market transactions.

Reserve requirement ratios are a powerful instrument of monetary policy: a change of a few percentage points in the reserve requirement can restrict or encourage the ability of depositories to make loans, which would have an immediate impact on the economy. The reserve ratio is seldomly used as monetary policy however, because monetary authorities prefer instruments that adjust gradually and smoothly.

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1) The President of the NY Federal Reserve Bank is a permanent member of the FOMC.

2) The Board of Directors is required by law to establish the discount rate every 14 days, subject to approval of the Board of Governors in Washington.

3) Until 1980, the Fed could set reserve requirements only for banks that chose to be members of the FRS (banks chartered by states don't have to belong to the FRS). But legislation in 1980 extended authority to set reserve requirements for all depository institutions, including non-member banks, savings and loan associations, credit unions, and others.

Because the discount window serves a different purpose in the US than in other countries, it is less central to monetary policy except as a preview of future credit conditions. Depository institutions in the US are discouraged from regarding the discount window as a source of funds for lending, but rather only for adjustment purposes when they have a temporary need to meet reserve requirements. Depository institutions which may need funds temporarily may also borrow from another depository institution that temporarily has an excess of reserves. The rate on such "federal funds" is called the federal funds rate, and it is one of the most closely watched interest rates in the US due to its fast and efficient nature.

The policy instrument most used by the Fed is open market operations, or the purchases and sales of Government and other securities. Purchases inject reserves into the financial system thereby stimulating money growth and credit. Sales have the opposite effect, reducing reserves and slowing money growth.

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