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BALANCED BUDGET TALKING POINTS #1: WHAT A BALANCED FEDERAL BUDGET WITH TAX CUTS WOULD MEAN TO THE ECONOMY

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Congress's balanced budget plan with tax cuts will lead over the next seven years to greater business investment, higher earnings per hour, and faster economic growth than under current law. The following are the findings of an analysis by The Heritage Foundation using one of the principal econometric models of the U.S. economy. According to the model, the balanced budget plan with tax relief would mean:

- ✓ **An additional \$32.1 billion in real disposable income** over the period 1995 through 2002.
- ✓ **An additional \$66.2 billion in consumption expenditures** over the period 1995 through 2002.
- ✓ **An additional \$88.2 billion in real non-residential fixed investment** over the period 1995 through 2002.
- ✓ **An additional 103,700 housing starts** over the period 1995 through 2002.

The analysis is important because many critics of the budget plan have expressed the concern that slowing the growth of federal spending to balance the budget in seven years will cause an economic downturn, if not a recession. Many supporters of the plan, on the other hand, claim that a balanced budget will reduce interest rates and spur productive, private-sector investment and economic activity. The Heritage analysis indicates the supporters are correct.

Economists at The Heritage Foundation conducted an interim econometric analysis of the plan using the econometric model developed by Laurence H. Meyer & Associates. The analysis is based on the Congressional Budget Resolution, as passed by Congress in May, which forms the overall structure of budget legislation now moving through Congress, and the Senate Finance Committee's

description of tax policy changes.¹ The Meyer model was used to gauge the general effects that key components of the budget would have on the economy. The Heritage Foundation's simulation of the budget plan strongly indicates that the general trend of economic activity will improve significantly during the "glide path" to a balanced budget as compared with a baseline of continued deficits under current law.

Laurence H. Meyer & Associates is a nationally recognized economic consulting firm. The Meyer model is used by many major public agencies and private firms. Among them: the President's Council of Economic Advisers, the Office of Management and Budget, the Board of Governors of the Federal Reserve, the Congressional Budget Office, the National Association of Realtors, the National Association of Home Builders, and the Ford Motor Company.²

The Baseline Projection

Heritage used projections of economic activity under current budget and tax policy prepared by Laurence H. Meyer & Associates as the economic baseline against which the Congress's budget and tax plan is compared. This baseline forecast (dated August 1995) projects that under current law the federal deficit continuously worsens during the projection period, from a fiscal year 1995 level of \$162.1 billion to a fiscal year 2002 level of \$257.4 billion. According to the baseline forecast and projection, the average annual growth in inflation-adjusted gross domestic product associated with these continuing deficits is 2.48 percent.³

The Balanced Budget Simulation

To conduct the simulation of the congressional budget plan, Heritage economists adjusted only those elements of the Meyer baseline that deal with federal spending and federal tax policy. The spending levels embodied in the Congressional Balanced Budget Resolution were introduced into the model in such a way that the resulting simulation mirrored the priorities defined in the resolution. For instance, the growth rates for both Medicare transfers and Medicaid grants were limited to levels called for within the budget resolution. Similarly, welfare spending was limited to a growth rate of 3.5 percent per year after 1997. Increases in national defense spending were applied primarily to Department of Defense procurement programs. And spending decreases in government purchases and transfer payments were assumed until a balanced budget was reached in 2002.⁴

With respect to changes in tax policy, the model was adjusted to reflect the new average tax rates that individuals and businesses would face if Congress enacted the changes in tax deductions and allowances defined by the Senate Finance Committee in the Chairman's Mark of October 16, 1995. Heritage calculated the changes in average effective federal tax rates that would result from adoption of family tax relief and various changes in the tax treatment of IRAs, health care costs, and estate taxes. These tax policy changes were used to adjust the model's average rate for individuals. Also incorporated were proposed changes in the taxation of individual and corporate capital gains, principally the exclusion of 50 percent of capital gains for individuals, the capping of the corporate

1 H. Con. Res. 67, Concurrent Resolution on the Budget for Fiscal Year 1996; Senate Finance Committee, "Estimated Budget Effect of Revenue Reconciliation Provisions of Chairman's Mark...", October 16, 1995.

2 Laurence H. Meyer & Associates long has earned top honors for forecasting accuracy when compared against similar firms. In 1993, LHM&A won the "Blue Chip" forecasting award for the years 1989-1992. LHM&A was ineligible for the award in 1994, but again was rated the most accurate forecasting firm in the United States.

3 Gross Domestic Product is the value of all final sales produced in the United States.

4 For a more detailed explanation of the policy assumptions used, see the Technical Notes at the end of this report.

Table 1

Balanced Budget Simulation Compared with No Change in Budget or Tax Policy: 1994-2004

		1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Gross Domestic Product (Billions of 1987 Dollars)	Balanced Budget (no recession)	5344.0	5506.2	5641.2	5783.7	5898.7	6003.7	6164.0	6374.1	6564.0	6753.1	6958.0
	Current Law (no recession)	5344.0	5506.4	5651.6	5779.4	5882.3	6008.8	6181.1	6380.5	6553.2	6739.5	6937.9
	Difference	0.0	-0.3	-10.4	4.4	16.5	-5.0	-17.2	-6.5	10.8	13.6	20.1
Real Personal Disposable Income (Billions of 1987 Dollars)	Balanced Budget (no recession)	3835.4	3965.2	4060.9	4173.8	4255.3	4339.8	4460.4	4599.7	4728.6	4857.3	4988.6
	Current Law (no recession)	3835.4	3967.2	4067.8	4151.4	4232.7	4336.3	4466.2	4602.3	4727.5	4857.2	4985.3
	Difference	0.0	-2.0	-6.9	22.4	22.6	3.5	-5.8	-2.7	1.0	0.2	3.2
Real Consumption Expenditures (Billions of 1987 Dollars)	Balanced Budget (no recession)	3579.6	3682.7	3771.0	3864.1	3944.2	4021.7	4123.9	4245.4	4362.3	4486.2	4613.7
	Current Law (no recession)	3579.6	3683.3	3772.0	3848.2	3921.0	4008.4	4119.3	4241.6	4355.4	4477.2	4600.2
	Difference	0.0	-0.5	-1.0	15.9	23.2	13.3	4.6	3.8	6.9	9.0	13.5
Real Nonresidential Fixed Investment (Billions of 1987 Dollars)	Balanced Budget (no recession)	672.4	768.5	810.7	848.3	884.1	911.0	958.2	1035.2	1107.7	1172.8	1249.3
	Current Law (no recession)	672.4	768.4	811.8	844.7	868.6	897.1	949.3	1018.0	1077.2	1133.5	1202.0
	Difference	0.0	0.0	-1.1	3.6	15.5	13.8	8.8	17.1	30.5	39.2	47.3
Total Industrial Production (1987 = 100)	Balanced Budget (no recession)	118.1	121.6	124.5	128.1	131.0	133.3	136.9	142.2	146.6	150.8	155.2
	Current Law (no recession)	118.1	121.6	124.5	127.4	129.7	132.5	136.5	141.3	145.1	148.9	153.0
	Difference	0.0	0.0	-0.1	0.7	1.3	0.8	0.4	0.8	1.5	1.8	2.2
Consumer Price Index (Annual % Change)	Balanced Budget (no recession)	2.6	3.0	2.9	2.8	2.1	1.5	0.9	1.1	1.2	1.2	1.3
	Current Law (no recession)	2.6	3.0	3.1	3.0	2.2	1.8	1.5	1.8	1.9	2.0	2.2
	Difference	0.0	0.0	-0.2	-0.2	-0.1	-0.3	-0.6	-0.7	-0.7	-0.8	-0.9
Federal Funds Rate	Balanced Budget (no recession)	4.2	5.8	5.7	5.4	5.1	4.7	4.5	4.3	4.1	3.9	3.7
	Current Law (no recession)	4.2	5.8	5.7	5.4	5.1	4.9	4.8	4.7	4.6	4.5	4.5
	Difference	0.0	0.0	-0.1	-0.1	-0.1	-0.2	-0.3	-0.4	-0.5	-0.6	-0.7
First-time Mortgage Interest Rates	Balanced Budget (no recession)	8.4	8.1	7.8	7.5	7.3	6.9	6.6	6.4	6.1	5.9	5.7
	Current Law (no recession)	8.4	8.1	7.9	7.6	7.3	7.1	6.8	6.7	6.5	6.4	6.4
	Difference	0.0	0.0	0.0	-0.1	0.0	-0.1	-0.2	-0.3	-0.4	-0.5	-0.7
Private Housing Starts (thousands of units)	Balanced Budget (no recession)	1445.9	1312.5	1333.5	1352.0	1273.8	1214.0	1256.1	1354.8	1382.9	1402.6	1414.4
	Current Law (no recession)	1445.9	1314.0	1332.5	1316.5	1235.7	1213.3	1266.1	1343.6	1354.4	1374.7	1387.4
	Difference	0.0	-1.5	1.0	35.6	38.1	0.7	-10.0	11.2	28.6	27.9	27.0
Compensation per Hour (Annual Rate of Increase Less CPI)	Balanced Budget (no recession)	0.6	0.8	0.9	0.9	1.3	1.3	1.3	1.0	0.9	0.9	0.9
	Current Law (no recession)	0.6	0.8	0.8	0.8	1.3	1.2	1.1	0.9	0.9	0.8	0.8
	Difference	0.0	0.0	0.1	0.1	0.0	0.1	0.2	0.1	0.0	0.1	0.1

Source: Heritage estimates using the Laurence H. Meyer & Associates Macroeconomic Model

tax rate on capital gains at 28⁵ percent, and other major tax policy changes in the Chairman's Mark that would affect businesses.

Table 1 indicates how balancing the federal budget in seven years while cutting taxes would affect the U.S. economy. Critics of balancing the budget and simultaneously cutting taxes argue that these changes will send the economy into a recession. As Table 1 shows, the simulation not only results in no such recession, but indicates that the economy would generally grow slightly faster with the proposed budget and tax changes than without them. Over the seven-year forecast horizon, inflation-adjusted gross domestic product grows by \$10.8 billion more with these public policy changes than without them, and at no time during this period does the economy become recessionary (see Chart 1).

There appear to be three principal forces behind this growth in economic activity.

First, the tax cuts add \$32.1 billion above baseline to real household disposable income during the period 1995-2002.

This growth in the real purchasing power of average Americans explains the higher levels of consumption expenditures under the policy of a balanced budget with tax cuts than under the baseline of continuing deficits and high taxes.

- ☞ Total real consumption expenditures are above baseline every year after 1996.

Second, balancing the budget and cutting taxes leads to greater investment in plant and equipment that, in turn, leads to higher levels of productivity (see Chart 2).

The simulation indicates that households and businesses will face lower interest rates under the balanced budget and tax cut plan than under current budget and tax policy.

- ☞ For example, the federal funds rate would fall from 5.8 percent in 1995 to 4.1 percent by 2002 in the simulation, which is 0.5 percentage points lower than the baseline.
- ☞ 10-year and 30-year government notes would have significantly lower yields by 2002 than in the baseline of continued deficits.
- ☞ The contract rate for first-time mortgages would drop faster under a balanced budget with tax cuts than in the baseline, to 6.1 percent in 2002 rather than 6.5 percent. This means that the budget and tax plan will save a home borrower of \$100,000 about \$10,000 over the life of a 30-year mortgage.

All of these downward interest rate movements when combined with lower taxes support higher growth in household and business purchases of durable goods, homes, and factories.

- ☞ Total housing starts would be 2.1 percent higher than in the baseline by 2002, according to the simulation.

5 Heritage did not attempt to estimate the influence of every tax policy change on the direction of average tax rates for individuals and businesses. A number of policy changes contained in the Chairman's Mark produce very small federal revenue effects and do not appear as variables in the Meyer model. Thus, our estimates of how the tax policy changes affect incomes and gross domestic product are conservative. Incorporating every one of the tax changes in the Chairman's Mark would likely increase the positive economic effects of the budget and tax plan.

Chart 1

Real Gross Domestic Product Current Law vs. A Balanced Budget

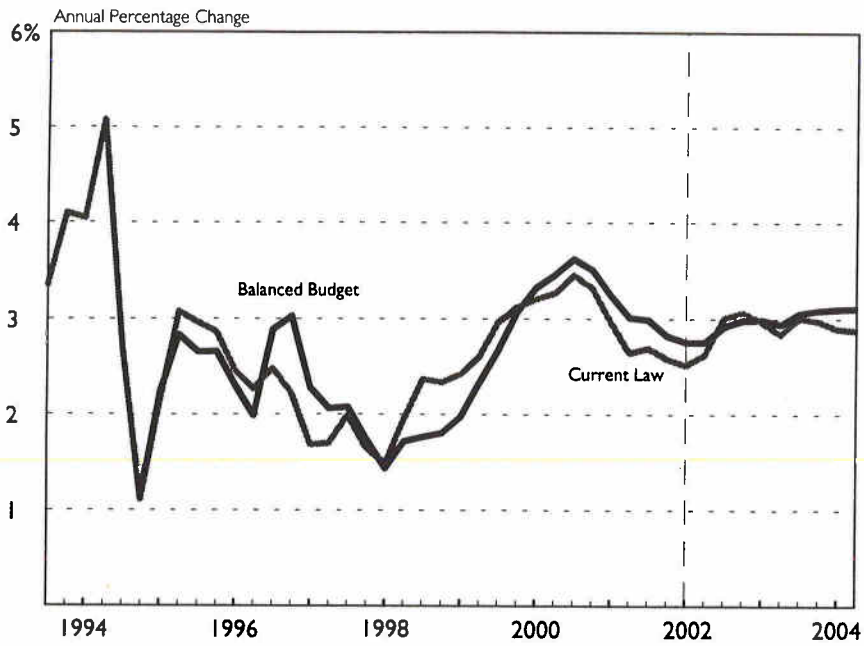
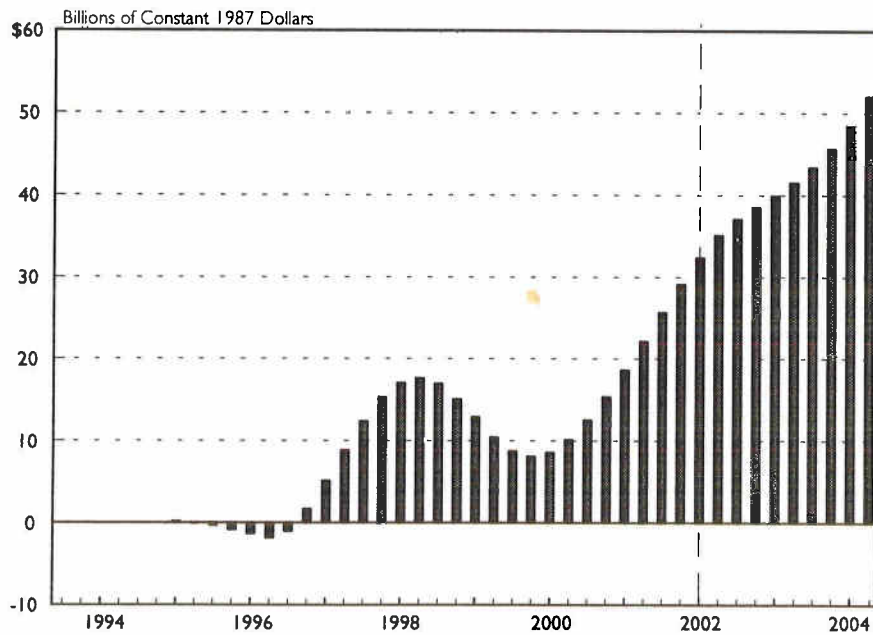


Chart 2

Additional Non-Residential Fixed Investment From A Balanced Budget



- ☞ Investment in business machinery would be 2.7 percent higher than in the baseline, with the computers component of business durable equipment outgrowing the baseline by 2.3 percent and all other equipment purchases ending 2.9 percent higher in 2002 than in the baseline.

The increase in capital investment denotes a movement in savings from cash-based accounts to capital-based assets. In other words, households and businesses are increasing their purchases of more productive and longer-term investments. These investments would have several positive effects. In particular:

- ☞ Real compensation per hour for workers would increase faster (and be the same or higher in every year) than the baseline, and industrial production for businesses would be higher.

The simulation shows slightly slower growth in GDP than the baseline in 1996. This temporary slower growth is due to reduced federal government purchases. However, the shift in savings from cash-based accounts to capital-based assets generally supports greater economic growth after 1996. The continued purchases of durable goods and equipment by households and businesses more than offsets reductions in government spending.

Third, the reduction of federal government spending in the private economy leads not only to a stronger macroeconomy, but to one with less inflation.

Both the Consumer Price Index and the Producer Price Index would grow more slowly with a balanced budget plan and tax cuts than without them. For example:

- ☞ The average growth in the CPI, according to the simulation, would be 1.94 percent per year, while the baseline forecast projects an annual average growth rate of 2.29 percent.

It should be noted that the simulation also shows a slightly higher unemployment rate than the baseline in each year after 1995. This slight growth in projected unemployment stems from two factors, one of them a normal feature of economic change and the other based on an assumption about monetary policy.

First, the reduction in government spending would mean layoffs in the public sector and in firms supplying goods and services to the government. Second, the simulation performed by Heritage assumes that the Federal Reserve System makes no change in the reserve requirements of its member banks and refrains from stimulating the economy by increasing the growth of monetary reserves. This assumption means relatively lower levels of growth in consumption expenditures and employment when compared with a simulation, also performed by Heritage and using the Meyer model, that assumes the Federal Reserve reacts to the slowdown in government spending by easing constraints on banks. It is worth noting that this second simulation (where the Fed stimulates short-term economic activity by expanding the supplies of money and credit) yields unemployment rates that are the same or better than the baseline. The unemployment numbers shown are a worst-case scenario when compared to model simulations which assume a reaction by the central bank.

This interim analysis of Congress's budget and tax plan may surprise both its supporters and its critics. On the one hand, supporters may have expected the economy to respond to a balanced budget with tax cuts more immediately than the analysis shows. But the plan's supporters should take note that, while these changes over the seven-year forecast period are significant, the major impact of these policy changes occurs not immediately, but steadily—over the period in which the budget is balanced and thereafter. Further, the tax changes, while significant, are only a small adjustment in today's code. Congress would need to enact major reforms of the code to spur the level of capital formation and growth that proponents of, say, a flat tax predict. If Congress were to make pro-growth reforms in federal tax policy (such as enacting a flat tax), the future pattern of the econ-

omy likely would improve much more than it would as the result of the relatively modest tax changes now being considered.

Critics of the balanced budget plan, on the other hand, should recognize that the plan generally supports their objective of economic growth at lower interest rates and lower inflation.

Technical Notes

The following policy assumptions were accounted for:⁶

- ✓ **Military spending**—90% of the spending increases over the next seven years was applied to the procurement account. The other 10% was applied to Department of Defense civilian employment increases. Zero percent real growth was assumed in 2003 and 2004.
- ✓ **Agriculture**—The \$13.4 billion savings from decreased agriculture subsidies called for in the budget resolution was spread over seven years in the following distribution: 1996 (\$0.6), 1997 (\$1), 1998 (\$1.6), 1999 and 2000 (\$2), 2001 (\$2.6), 2002 (\$3.6). A reduction of \$3.6 billion was assumed in 2003 and 2004.
- ✓ **Medicare**—Reductions in the rate of growth for Medicare follow those in the budget resolution. A growth rate of 7.63 percent was assumed for 2003 and 2004.
- ✓ **Welfare**—Cash aid welfare spending growth rates were capped at 3.5 percent.
- ✓ **Foreign aid**—Transfer payments to foreigners were decreased according to the reductions called for in the budget resolution for account number 150 (international affairs).
- ✓ **Medicaid**—The growth rate in Medicaid was held to the levels called for in the budget reconciliation: 7.2 percent in 1996, 6.8 in 1997, and 4 percent thereafter.
- ✓ **Civilian and military compensation** per person was held constant after 1998.
- ✓ **Non-defense federal civilian employment** was decreased by 20 percent, spread evenly between 1996 and 2000.
- ✓ **All other spending**—for government purchases and transfer payments—was reduced in the same proportion called for in the budget resolution until balance was reached in 2002.
- ✓ **Capital gains taxes**—A 50 percent exemption of capital gains was assumed for taxation purposes through 2004.
- ✓ **Family tax relief**—Federal receipts from individual income taxes were reduced according to the yearly levels in the Joint Tax Committee's score of the Senate's tax package.
- ✓ **Other provisions** of the Senate tax relief package were accounted for by changing the effective tax rates on wages, dividends, and individuals.

6 For further information or clarifications, please contact the authors.