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Preliminary Assessment of the Economic and Public Finance Effects of the Budget Resolution, Fiscal Years 1998–2002

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NOTE: *The following analysis of the economic and public finance effects of the pending budget resolution is based on the highly preliminary estimates of tax and spending changes for fiscal years (FY) 1998–2002 available from the U.S. House and Senate budget committees. Thus, this forecast of the resolution's effects could change as additional and revised data become available.*

Recently, the U.S. Senate and House of Representatives adopted a budget resolution that supporters claim will result in a balanced budget and a growing economy by the end of FY 2002. Although many of the budget plan's details remain unclear, recent congressional budget hearings and floor debate make possible a preliminary assessment of how the policy changes behind the resolution would affect the economy and the deficit.

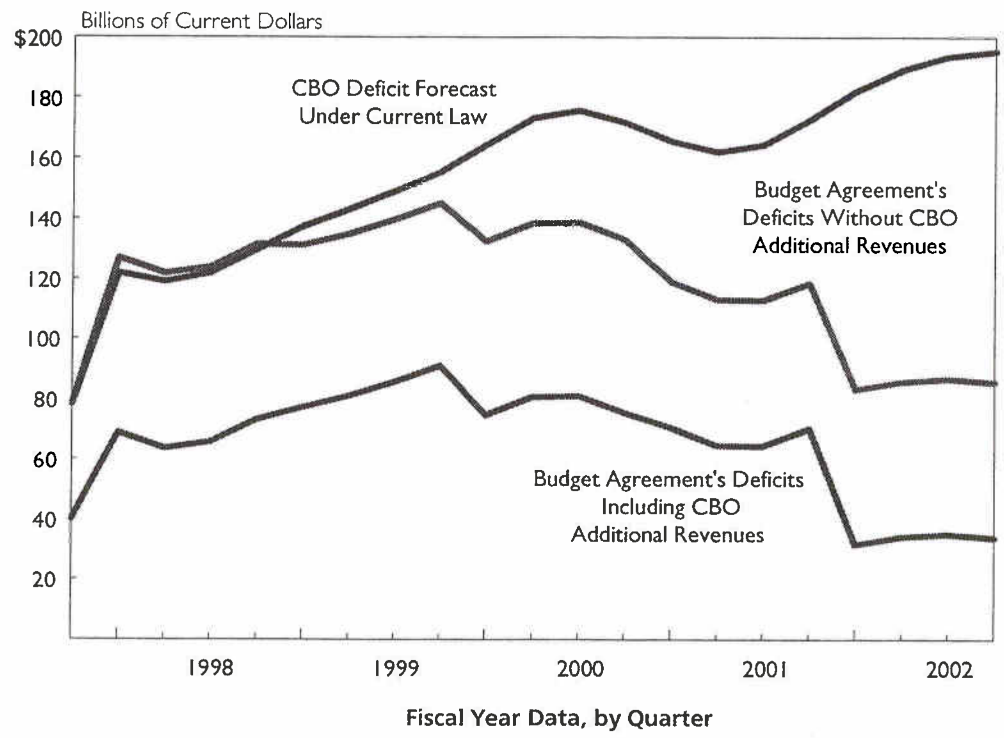
Economists at The Heritage Foundation used the economic assumptions of the Congressional Budget Office (CBO) for fiscal years 1997–2002, the CBO's spending and revenue baselines for these fiscal years, and the available details of the budget resolution to analyze the plan's dynamic economic and budgetary impacts. These CBO assumptions about the economy and the budget (otherwise known as the "current law" baseline), as well as the spending and tax details from the budget resolution itself, were incorporated in the January 1997 U.S. Macroeconomic Model of the WEFA Group.[1] The assumptions made by Heritage economists (see Appendix) were not unfavorable to the resolution. It should be noted also that this Heritage analysis assumes that future (out-year) spending reductions will be enacted by future Congresses, even though the budget resolution obviously cannot make this guarantee.

According to this simulation of the budget plan, several important points can be made:

- **The federal budget is not balanced by the end of FY 2002.** Despite spending reductions over a period of five years and additional revenues of $45 billion for each of those five years, the budget fails to balance at the end of FY 2002. According to the simulation, the deficit will still be $34 billion at the end of the five-year plan.
- **The budget resolution fails to boost the economy.** Heritage's simulation of the five-year budget resolution shows that the plan modestly depresses the general economy, as measured by inflation-adjusted gross domestic product (GDP). In FY 1998, for example, GDP falls by only $1.7 billion (0.02 percent); but by FY 2002, GDP is $33 billion below baseline, or has fallen by 0.4 percent.
- **Employment and investment show little improvement.** Supporters of the budget resolution have advanced the plan in part because they say it would lead to more jobs and greater investment. The Heritage simulation, however, indicates that the plan has a negligible effect on both. Employment remains slightly below current law baseline throughout the simulation, and investment fails to grow at rates significantly above baseline.

Chart 1

Even with CBO's $250 Billion Windfall the 1997 Budget Deal Will Not Balance the Budget by FY 2002



Source: Heritage estimates using the WEFA Mark 11 model. The current law baseline is CBO's January 1997 uncapped baseline.

1 See the accompanying technical appendix for a description of The Heritage Foundation's use of the WEFA Model and the various steps incorporated to simulate the budget resolution. It should be noted that the methodologies, assumptions, conclusions, and opinions herein are entirely those of Heritage Foundation economists and have not been endorsed by, and do not necessarily reflect the views of, the owners of the WEFA Mark 11 model.

Table 1

The Economic and Fiscal Effect of the 1997 Budget Resolution, Fiscal Years 1998-2002

	FY1998	FY1999	FY2000	FY2001	FY2002
Real Gross Domestic Product (Billions of 1992$)					
Budget Resolution	$7,173.7	$7,317.1	$7,477.9	$7,638.8	$7,772.3
Current Law	7,175.4	7,330.8	7,487.2	7,644.4	7,805.5
Dollar Difference	-1.7	-13.7	-9.3	-5.6	-33.2
Employment (millions)					
Budget Resolution	123.61	124.82	126.16	127.98	128.82
Current Law	123.61	125.03	126.50	128.03	129.36
Employment Difference	0.00	-0.20	-0.34	-0.04	-0.54
Unemployment Rate					
Budget Resolution	5.58%	5.93%	6.15%	6.10%	6.36%
Current Law	5.52%	5.76%	5.88%	5.98%	6.00%
Change in Rate	0.06	0.17	0.27	0.12	0.36
Federal Funds Rate					
Budget Resolution	5.01%	4.76%	4.52%	4.23%	3.91%
Current Law	5.03%	4.90%	4.86%	4.76%	4.75%
Change in Rate	-0.03	-0.14	-0.34	-0.53	-0.84
Personal Disposable Income (Billions of 1992$)					
Budget Resolution	$5,391.6	$5,512.4	$5,624.4	$5,749.3	$5,851.4
Current Law	5,381.9	5,513.3	5,640.4	5,776.3	5,925.1
Dollar Difference	9.70	-0.86	-16.00	-26.98	-73.75
Non-Residential Fixed Investment (Billions of 1992$)					
Budget Resolution	$849.5	$879.3	$904.8	$932.6	$957.6
Current Law	844.3	874.5	901.1	924.6	951.2
Dollar Difference	5.20	4.80	3.70	8.00	6.40
Federal Deficit (Billions of Dollars, Unified Basis)					
Budget Resolution	$67.6	$83.6	$77.9	$67.2	$33.6
Current Law	123	146	171	166	190
Dollar Difference	-55.36	-62.35	-93.11	-98.76	-156.38
Inflation (Annual Change in CPI)					
Budget Resolution	2.88%	2.93%	2.78%	2.79%	2.46%
Current Law	2.91%	2.99%	2.98%	3.00%	3.03%
Change in Rate	-0.03	-0.06	-0.20	-0.21	-0.57

Source: Heritage estimates using the WEFA Mark 11 model. The current law baseline is CBO's January 1997 uncapped baseline.

"The Case for Repealing the Estate Tax," Heritage Foundation *Backgrounder* No. 1091, August 21, 1996, pp. 24–26.

Declarations of Capital Gains. Heritage economists adjusted the income tax base to reflect a higher level of capital gains declarations. The base was increased to reflect estimated elasticities associated with significant capital gains rate reductions; see Leonard Burman and William Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994). For the first year after the reduction in the capital gains tax rate, the base grows by a ratio of 1.9 percent to every 1.0 percent reduction in the capital gains tax rate. Thereafter, the base is permanently higher by the following ratios: FY 1999: 0.96 to 1; FY 2000: 0.48 to 1; FY 2001 and FY 2002: 0.24 to 1.

Corporate AAA Bond Rates. An average decrease in corporate bond rates of 29 basis points was assumed as a result of lowering the capital gains tax rates by 30 percent.