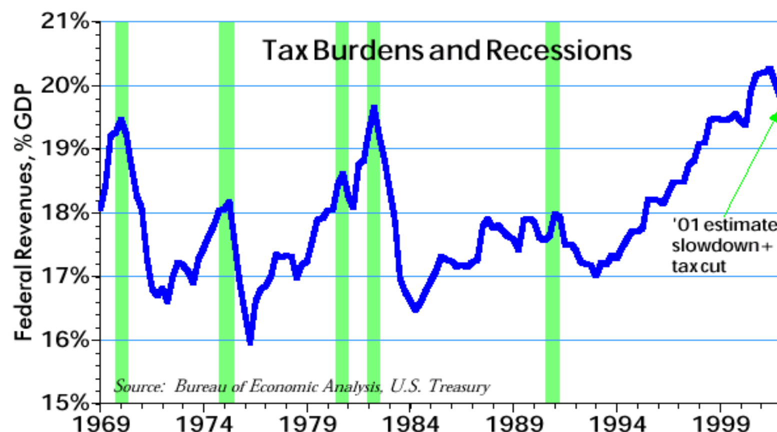
Is Fiscal Policy Too Tight?

By Thomas E. Nugent

In the late-'90s, the confluence of strong economic growth, decelerating federal government spending and substantial increases in tax rates (revenues) had the unexpected effect of producing enormous budget surpluses. As unexpected budget surpluses burst on the scene in the late 1990s, most mainstream economists weren't sensitive to the contractionary impact that surpluses can have on the economy. The reason was simple: none of their economic models ever included the forecast of a substantial surplus. As the 1990s came to an end, virtually all financial market observers and politicians rejoiced that budget deficits were gone and that the U.S. had entered a period of fiscal stability. Politicians on both sides of the aisle viewed the new world of budget surpluses as an opportunity to save Social Security, to cut Federal debt and to lower taxes.

Budget deficits or budget surpluses are neither good nor bad, they are fiscal policy options that can stabilize or de-stabilize an economy. The U.S. economy, under Reagan, Bush and early Clinton experienced higher not lower rates of economic growth at a time when budget deficits were at record levels and tax rates were on the decline. Over the past twenty years, a period of record budget deficits, the stock market, as measured by the Dow Jones Industrial Average, increased from the 950 to over 11,000, providing ample evidence that budget deficits are not necessarily bad for an economy. On the other hand, budget surpluses are not necessarily good. As the budget surpluses began to expand dramatically in late 1999 and into 2000, the stock market appeared to be reversing the record up-trend of the Eighties and Nineties. One possible reason for the reversal: the growing budget surplus was sapping the savings of the private sector. Consumers were able to maintain their spending only through expanding debt to record levels.

Courtesy of Scott Grannis of Western Asset Management



By overtaxing the private sector, the government reduced savings. Historically, when the government drives the tax burden higher, recessions are usually the result (see exhibit). The lack of understanding of the contractionary effect of the budget surplus is evident in omnipresent commentary about the anticipated stimulative effect of President Bush's $40 billion tax cut this year. There is no stimulus in the tax cut if it only results in the reduction in the size of the budget surplus. The President's tax cut only makes the budget surplus less contractionary. It's one thing to run a budget surplus and remove savings when the economy is booming but running a budget surplus and removing savings when the economy is weakening is a sure

formula for economic malaise. President Bush's tax cut that takes effect this year should reduce the contractionary impact of the surplus but it is only a small step in the right direction.

Market observers are either relying on the Federal Reserve's lower interest rate policy to turn the economy around or President Bush's lower tax rates to stimulate consumer spending. However, monetary policy and low interest rates may not produce the intended result—maintain consumer spending. The reason is that consumer debt is already at record levels relative to income so lower rates may not lead to more debt-driven spending. The Japanese experiment to use lower interest rates to stimulate their economy has failed. The Japanese have been lowering interest rates for years—they are now below 1%--and still there is no response from their economy. To the extent that the U.S. consumer can't save and must borrow to pay taxes, there is a risk that he won't be able to sustain this economy much longer. The $600 per couple Bush tax cut this year may act as a short-term palliative but is insufficient to trigger a new expansionary phase.

Then there is the strong U.S. dollar. With U.S. interest rates falling sharply and the U.S. economy slowing, it is almost unimaginable that the greenback could have been hitting record highs. Traditional analysis can't explain this strange dichotomy. Yet, the budget surplus gives us another perspective on why the dollar is strong. As the government pays off debt and thereby reduces non-government savings, business and consumers are forced to sell real assets in an attempt to restore desired nominal savings. There is shrinkage in the amount of available investment alternatives that are equally as attractive as safe U.S. government bonds. With a shrinking pool of safe U.S. government investments, foreigners who want U.S. dollars continue to export to the U.S. at lower and lower prices to get the needed dollars, and convert local profits to U.S. dollars as well. (Foreigners are buying dollars, the equivalent of non-interest bearing U.S. government securities because there is a shortage of U.S. government securities.) In stock market parlance, there has been a short squeeze on the dollar. The rapidly collapsing budget surplus may provide a clue as to why the dollar has begun to weaken.

Early in 2001, jubilant fiscal planners forecast budget surpluses continuing at a $200 billion rate over the next six years. The implications are an equivalent private sector deficit. Can the U.S. consumer continue to have his savings drained at that rate and, at the same time continue to borrow to replace the excess taxes that he is paying in a budget surplus world? Unlikely. Something will have to give. Recent indications are that the budget surplus will shrink as unemployment compensation increases and tax receipts fall with the slowdown. Recently Treasury officials indicated that they were planning to borrow $51 billion in the quarter ending Sept. 30. In April of this year the forecast was for a planned reduction in the Federal debt of $57 billion. That $108 billion swing is the largest on record. Recent surprisingly large quarterly losses of corporations suggest that dramatically smaller corporate tax collections will contribute to further shrinkage in the government surplus.

A major risk to the economy in light of a shrinking surplus is reactive government policies that attempt to maintain, if not increase the budget surplus through raising taxes or not cutting them and reductions in federal government spending. According to the Associated Press, Representative Jim Nussle, House Budget Committee Chairman, is planning to force automatic spending cuts if this year's debt reduction ends up falling below the $155 billion the budget envisioned. "The problem around here is we have spent too much," Nussle told reporters at a recent interview. Any steps either to curtail spending or increase taxes (reduce the tax cut) will accelerate the economic downturn and virtually guarantee a prolonged recession. As the economy continues to deteriorate, an easy fiscal policy that restores savings is the only alternative to reversing a continued downward slide. The sooner the government realizes that an easy fiscal policy will cure a weak economy, the less chance there is that the U.S. will have to run substantial budget deficits.

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