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THE ECONOMIC IMPACT OF FEDERAL DEFICITS,
1984-1989

A STAFF STUDY

PREPARED FOR THE USE OF THE

SUBCOMMITTEE ON ECONOMIC GOALS AND
INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES



APRIL 13, 1984

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The Honorable Roger W. Jepsen
Chairman
Joint Economic Committee
Congress of the United States
Washington, D.C.

Dear Mr. Chairman:

Transmitted herewith is a study prepared for the Joint Economic Committee entitled, "The Economic Impact of Federal Deficits, 1984-1989." This study evaluates the economic effects through the balance of the decade of our enormous Federal deficits.

This study is an important addition to the debate over Federal deficits. Subcommittee members, the Joint Economic Committee and other Members of Congress will find it a valuable reference source.

Sincerely,

Lee H. Hamilton
Chairman
Subcommittee on Economic Goals
and Intergovernmental Policy

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Congress of the United States

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The Honorable Lee Hamilton
 Chairman
 Subcommittee on Economic Goals
 and Intergovernmental Policy
 Joint Economic Committee
 Congress of the United States
 Washington, D.C.

Dear Mr. Chairman:

Transmitted herewith is a study entitled, "The Economic Impact of Federal Deficits, 1984-1989." Using mathematical simulations of the economy, the study examines the impact of Federal budget deficits on U.S. GNP, housing, employment, savings, investment and productivity through 1989. This econometric analysis is the most extensive one yet conducted and documents the steady erosion we can expect in our economic base if these deficits are not promptly reduced.

The study was prepared by George Tyler of the Committee staff, with assistance from Paul Manchester and Doris Irwin. It utilized the Data Resources, Inc. econometric model to evaluate the impact of future deficits under a variety of conditions. If no action is taken by the Administration and Congress to reduce deficits, the study found that interest rates will continue rising, and the deficit will grow inexorably to \$306 billion by 1989. The study evaluates the economic impact of the Administration's March proposal, as well. It finds that this proposal is insufficient to reverse the deficit trend, or to prevent rising interest rates. The proposal will produce a Federal deficit in 1989 of \$176 billion, near the present high level.

These results warrant unusual attention because of the comprehensive dynamic computer simulations used to derive them. The conclusions are far more useful and realistic than the typical static analysis utilized to evaluate the impact of deficits. I believe members of the Subcommittee, the full Committee and other Members of Congress will find the study useful and informative.

The views expressed in the study are those of the author and do not necessarily represent the views of the Committee members or the Committee staff.

Sincerely,

Lloyd Bentsen
 Vice Chairman
 Subcommittee on Economic Goals
 and Intergovernmental Policy

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INTRODUCTION

This study examines the impact of large Federal deficits through the balance of the decade on U.S. economic growth, savings, investments and productivity. It utilizes mathematical simulations based on the Data Resources, Inc. Annual Econometric Model. Such simulations have only a spotty record in successfully predicting future economic variables, especially years in the future. They can be extraordinarily helpful, however, in evaluating the relative future impact of different macroeconomic policy patterns. The relative effect of various fiscal and monetary policy mixes on real GNP growth, for example, are readily determined using econometric simulations even if absolute future GNP levels cannot be confidently pinpointed. The use of econometric simulations permits the future impact of Federal policy on the economy to be evaluated in a realistic, dynamic context. For that reason, there is a sharp distinction between the future economic outlook derived from the analyses used in this study and those presented, in particular, in Administration budget documents. The analyses utilized for the budget and elsewhere, as well, give a different and essentially misleading static picture of the effects of Federal economic policy. Tax increases or spending cuts designed to shrink future deficits, for example, directly influence a multitude of variables in addition to the actual magnitude of deficits. They may reduce economic growth, for one, altering future investment and productivity as well as Federal receipt and expenditure streams. These second order or dynamic effects can be quite substantial. Yet, they have been largely ignored in the deficit debate. This study is designed to rectify that shortcoming.

The analyses of the dynamic effects of Federal deficits are divided into two chapters. The future economic impact of a failure by the Administration and Congress to adopt any tax and spending policy designed to reduce looming Federal deficits is evaluated in Chapter I. The econometric simulations utilized in that analysis found that a hands-off attitude toward Federal deficits will cause interest rates to continue rising and will reduce U.S. investment and productivity. The recovery will continue this year, but crowding-out will push interest rates up and sharply reduce future economic growth. The deficit will rise steadily to \$306 billion by 1989 when government interest payments on the debt will exceed \$236 billion. Continued high real interest rates will greatly intensify the unbalanced nature of the recovery. Lagging housing and foreign sector firms will continue to drag down the rate of growth. The housing industry will return to a recession pattern through at least 1989. Inventory and nonresidential fixed investment will increase handsomely this year. But continuing high real interest rates through 1989 will depress savings, investment and productivity well below historic levels.

The future economic impact of the Administration's March \$150 billion deficit-reduction proposal is reviewed in Chapter II. The simulations indicate that the proposal is of insufficient strength to reverse the deficit trends. It will have virtually the same debilitating impact on future investment, savings and productivity as the no-action scenario examined in Chapter I. Its modest size will not prevent higher interest

rates this year which will sharply reduce economic growth in 1985 and beyond. In slowing the recovery, the proposal will cause government receipts to lag and spending to rise. This combination of modest deficit reduction and slower growth will cause Federal interest costs on the debt to continue rising rapidly and prevent progress against the deficits. Even as late as 1989, the Administration's proposal will result in a Federal deficit of \$176 billion, quite near current levels. Finally, the proposal will not halt the downward trend in U.S. productivity growth.

The simulations utilized in this analysis found that a deficit reduction package larger than proposed by the Administration is needed to actually achieve a reversal of the deficit trend. By substantially reducing Treasury demands for credit, a larger package would permit interest rates to decline and enable a robust recovery to continue beyond 1984. In sparking more robust growth and lower interest rates than the meek Administration proposal, such a package would enable the present investment boom to persist. As a consequence, such a package, similar in magnitude to the proposal recently offered by Senate Democrats and approved by the House of Representatives, would succeed in reversing the sagging U.S. productivity trend, as well.

Summary

If no action is taken by the Administration and Congress to reduce Federal deficits:

- * The Federal deficit will reach \$306 billion by 1989.
- * The National debt will more than double by 1989 to \$2.85 trillion. Government outlays to pay interest on the debt will double to \$237 billion in 1989.
- * Crowding-out of financial markets by the deficit will occur in 1984 and 1985, pushing real interest rates up another percentage point by 1985.
- * The current investment boom will end and economic growth will fall nearly one-half in 1985.
- * High interest rates will decrease housing starts by fifteen percent in 1985. They will remain at that level through 1989.
- * The deficit-bloated dollar will enlarge the net export deficit 13-fold by 1989 and cost the U.S. 3 million jobs in export and basic industries in addition to the 1.2 million jobs already lost.
- * National investment on plant and equipment will sag and productivity growth will decline 10 percent below even the weak level of the 1970's, cutting GNP in 1994 by \$2,000 per person.

If the Administration's \$150 billion deficit-reduction package proposed in March is enacted:

- * The proposal is too weak to reverse the rising deficit trend and Federal deficits will remain at or above \$173 billion through the end of the decade.
- * The national debt will double to reach \$2.8 trillion by 1989.
- * Interest rates will rise in 1984, and Government outlays for interest on the national debt will jump 50 percent to exceed \$170 billion annually by 1989.
- * High interest rates, lagging exports and investment will slow the recovery after 1984. Real GNP will only grow at the same speed it would if no steps at all are taken to reduce the deficit between now and 1989.
- * Slower growth and high interest rates rise will hobble U.S. investment in new, more productive plant and equipment.
- * The share of personal disposable income being saved by individuals through 1989 will drop over 20 percent from the post-war average. As a result, over \$260 billion less will be saved from 1985 to 1989 than would have been saved at historic savings rates.
- * Productivity-enhancing investment will not rise above the recession level of recent years when less than 12 cents of every GNP dollar was spent on new plant and equipment.
- * The declining U.S. productivity growth trend will not be reversed. It will fall more than 20 percent below the pace of the 1960's and reduce future GNP growth by \$448 billion between 1985 and 1989 -- or \$1,700 per person.

CHAPTER I

Economic Impact of Federal Deficits

The economic and budgetary impact through 1989 of prospective Federal deficits are evaluated in this chapter under the assumption that deficit-reduction steps are not taken by the Administration or Congress. This prospective impact is compared with recent United States economic experience.

The simulations used in this analysis are modifications to the Data Resources, Inc. (DRI) annual econometric model. The specific baseline utilized in evaluating the economic impact of inaction on looming federal deficits is the DRI current services budget projection for 1984-1989. Current services budgets depict an economic outlook based on existing federal tax and spending statutes. They do not contain suggested policy revisions. That is, an econometric simulation of current service budgets will depict future trends in the absence of any federal action to reduce deficits.

The specific baseline selected for simulations bears importantly on econometric results. The DRI current services budget estimates are in line with other such estimates. They closely resemble the most recent current services baseline estimates, for example, prepared by the Congressional Budget Office, and presented in the CBO document An Analysis of the President's Budgetary Proposals for Fiscal Year 1985, (February, 1984). The modest CBO-DRI areas of difference in current services estimates are noted in the March, 1984 DRI publication, Review of the U.S. Economy.

The actual economic point estimates for out-years presented in this analysis are based on dynamic interactions within the simulations involving Federal budgets, monetary policy, the international economy and domestic demand and supply variables. These dynamic interactions have dramatic effects on nominal values. Evaluating the impact of prospective deficits in a dynamic context, as this study does, provides a far more realistic perspective than does the more traditional and much more common static context.

Assumptions:

Evaluating the economic outlook consistent with specific government policy mixes in a dynamic context requires the selection of monetary and fiscal policy assumptions. Selecting fiscal policy assumptions was straightforward. The DRI current services budget baseline denoting future spending and tax trends was adjusted for the particular deficit reduction proposal under review. Since the economic impact of inaction on the deficits is reviewed in this chapter, that baseline was not revised to conduct the simulation examined here. Simulations evaluating the Administration's March deficit-reduction proposal are examined in Chapter II. The DRI current services estimate of future tax and spending streams

was adjusted to reflect the Administration's three-year \$150 billion package as noted in more detail in that chapter. A similar procedure was utilized with simulations evaluating the economic impact of a larger deficit-reduction package, as well.

The monetary policy assumptions utilized are more subjective. The simulation results discussed below are based on the assumption that a moderate monetary policy will continue to be pursued by the Federal Reserve Board. The growth of M1, for example, is presumed to remain at recent growth rates and within the current Federal Reserve Board's target range of 4-8 percent (fourth quarter to fourth quarter). Underlying this presumption is continued Federal Reserve Board devotion to price stability through the balance of this decade.

That devotion may be sorely tested in 1984 and 1985, for inflationary signs abound. The recovery is continuing at an unusually robust rate with real GNP growth at an annual rate being revised upward to 5 percent in the fourth quarter of 1983 (83:4). It rose even faster during 84:1. Indeed, a genuine capital spending boom is underway, confirmed by both McGraw-Hill and Commerce Department surveys. For example, the Department's January-February survey of capital spending plans found that plant and equipment spending is expected to rise 12.2 percent this year in real terms -- up over 40 percent from the 8.5 percent (real) projection based on its earlier November-December survey. This broad-based boom, led by autos, gas utilities, textiles, electrical machinery and railroads will certainly tail off. According to Wharton Econometric projections, it will slacken to only a 5 percent annual pace by 84:4. Yet, its impact on capacity limits and prices this year will be magnified by increased inventory investment as industries reverse the 1983 trend which saw sales exceed inventory gains.

The current surge in nonresidential fixed investment comes even as a number of industries are already approaching full capacity. Overall, industrial capacity rests at 81 percent. But a number of industries, including plastics, paper and electrical machinery are closer to 90 percent. As a result, the leading indicator of inflation compiled by the Center for International Business Cycle Research has risen 14 percent in the last year. One component of that index, which measures 13 freely traded industrial inputs like tallow, rose an even faster 20 percent during the same period.

Other indicators of rising inflationary pressure exist. The number of firms reporting slower delivery of goods is rising sharply. At the comparable period following the 1974-75 recession, the vendor-performance indicator found that 50 percent of surveyed firms were experiencing delivery slowdowns. It sits at 67 percent now on a rising trend, up from 41 percent last year. Moreover, productivity growth fell to a scant .9 of one percent annual rate in 83:4 -- providing little cushion when wages and labor costs begin rising due to the surprisingly rapid decline in unemployment. Adding to the portents for faster inflation is the potential effect should the dollar decline anew on foreign exchange markets. A precipitous decline could add as much as two percentage points to the Consumer Price Index.

The GNP Price Deflator is on a strong upward trend. Since rising at an annual rate of 3.6 percent in 83:3, it has increased at progressively faster rates of 3.9 percent in 83:4 and a preliminary 4.4 percent in 84:1. Moreover, the fixed-weighted price index, designed to wash out the inflationary effects of a changing output composition, rose at an annual pace of 5.1 percent in 84:1 -- nearly a one percentage point jump from the 83:4 annual pace of 4.2 percent. This price surge paralleling the strikingly robust first quarter GNP growth has raised fears of a quick return to the traditional boom-bust cycle. Reinforced by rising credit demand, short-term rates have reflected that fear as investors have sought to maintain existing real interest rate levels in the face of rising prices. T-Bills have increased over 80 basis points since early February. The prime interest rate rose 100 basis points in late March and early April. And, 90-day Certificates of Deposit are now one percentage point above the 9.35 percent averaged in January. The Federal Reserve has reacted to this trend by increasing the discount rate to 9 percent from 8.5 percent April 9, for the first change in over 15 months. The Federal Funds rate has risen even more. Yet, these steps appear to be in response to market pressures rather than symptomatic of a switch in Federal Reserve policy. And, while the Federal Reserve is sensitive to inflation, the simulations utilized here assume that it does not cut short the recovery with tighter money.

Simulation Results

The percentage point increase in nominal interest rates over recent months has nearly restored real interest rates to the levels maintained throughout most of 1983. The simulations utilized to evaluate the economic impact of prospective Federal deficits indicate that increasing pressure in financial markets will continue to boost nominal interest rates in 1984 and 1985. More significantly, the pressure generated by Treasury financing operations will force real interest rates up, as well, over the next two years. They will ease down thereafter as economic growth slows, and the economic expansion will continue through 1989, albeit at a diminishing pace. The simulations project that real GNP will grow at an annual average of 3.5 percent from 1983 to 1989, including a robust 5.2 percent this year. As Table I notes, this period average is at the lower end of real GNP growth attained in other postwar recoveries, despite the fiscal thrust provided by deficits which rise steadily to a projected \$306 billion in 1989 from \$183 billion in 1984. This deficit picture is similar to results obtained from other economic impact assessments of deficits, including Congressional Budget Office evaluations.

Table 1
Real GNP Growth
During Postwar Recovery Periods
1948-1989

<u>Period</u>	<u>Growth Annual Average (%)</u>
1948-1953	4.9
1955-1957	3.5
1959-1969	4.4
1971-1973	5.0
1976-1979	4.7
Simulation (1983-1989)	3.5

Source: Economic Report of the President, February 1984 and
Economic Simulations by Joint Economic Committee.

As noted in Table II, Federal net interest payments on the debt will rise more than 100 percent to a projected \$237 billion by 1989. Crowding-out of capital markets by Treasury deficit financing operations will push up real interest rates through 1985. After spiking about 50 basis points in 1984 and 60 basis points in 1985, they are projected to subside slightly thereafter through 1989 in this simulation due to a slowing in real GNP growth beyond 1984.

Table II
Economic Impact of the Deficits
1984-1989

	1984	1985	1986	1987	1988	1989
Real GNP Growth (%)	5.2	3.2	3.7	2.7	3.3	3.4
Real Interest Rates (%) <u>1/</u>	5.4	6.0	5.7	5.3	5.0	4.8
Federal Deficit (Billions \$)	183	209	231	267	282	306
Net Interest Payments (Billions \$)	117	137	159	184	210	237

1/ New high grade Corporate Bonds.

Source: Joint Economic Committee Simulations.

Real GNP growth is projected to decline substantially from a robust 5.2 percent in 1984 to an average 3.3 percent thereafter through 1989. Contributing to this decline is a projected further weakening in the U.S. foreign trade sector as the dollar declines less than 10 percent over the balance of the decade. Slackening growth is projected to slow progress against joblessness after this year, as well, with unemployment still at 7.0 percent of the labor force at the end of the decade despite a sharp drop in the number of new market entrants.

The persistence of high real interest rates through the balance of the 1980's due to growing deficits will aggravate the unbalanced nature of the present recovery. As they traditionally do in recoveries, interest-sensitive industries played major roles in sparking the 1983 recovery. Yet, housing and exports, in particular, are not sharing fully in the current recovery. This situation is projected to worsen due to the deficits through 1989.

Housing:

Treasury deficit-financing pressure on capital markets will keep fixed rate, long-term nominal mortgage rates at or above current levels through 1989. And real mortgage rates in 1989 will be virtually identical to those projected for 1985. After this year, as a result, housing starts are projected to decline to about 1.5 million units annually through the balance of this decade. Housing starts were up sharply last year after three sluggish years. Yet, despite a substantial backlog in demand, activity fell well short of the average 1.9 million housing units on which construction was started annually in the late 1970's.

The stagnation of this key interest-sensitive industry due to the deficits will not enable housing to keep pace with family formations. As Table III notes, because of the collapse in housing construction over the 1980-1982 period, growth in households ran far ahead of growth in the net housing stock. This pattern will continue, although at a reduced pace, through 1989. The impact of the deficits on real interest rates will prevent the recovery from providing a compensatory spurt in housing sufficient to eliminate the housing supply gap. As a consequence, household formations will far exceed housing stock growth for the entire decade of the Eighties.

This weak housing outlook for the balance of the decade is in sharp contrast with that sector's experience during the two previous decades. From 1960 to 1979, the housing stock grew an average 2 percent faster than the number of households. From 1984 to 1989, however, fewer than eight additional housing units will be provided for every ten additional households; residential real fixed investments will actually decline in three of the five years from 1985-1989.

Table III

The Housing Outlook

	1960-1979	1980-1982	1984-1989
Change in the Housing Stock $\frac{1}{}$	1.3	.78	1.25*
Change in total households $\frac{1}{}$	1.27	2.07	1.63
Ratio of housing stock/ Household change	1.02	.37	.77*

$\frac{1}{}$ Million of housing units per year.

Source: Bureau of the Census and (*) Simulations by Joint Economic Committee.

Foreign Trade Sector:

A second major sector being severely damaged by deficits is U.S. export and import-competing industries. In adding several percentage points to domestic real interest rates, the deficits have lured billions in investment from abroad. The U.S. experienced a \$30 billion net foreign capital inflow in 1983 alone; for example. These capital inflows pushed the dollar up 46 percent in real trade-weighted terms on foreign exchange markets between 1979 and last December. U.S. exports plunged as a result, while imports surged. The merchandise trade deficit of \$60.6 billion in 1983 alone reduced real U.S. GNP nearly 2 percentage points. As the first full year of recovery, 1983 should have been a year of sharp improvement in the merchandise trade balance. Instead, it worsened by 66 percent. Moreover, since trade balances typically deteriorate as recoveries proceed, real GNP growth this year could again be suppressed 2 percentage points or more by the foreign trade sector due to the deficit. Indeed, the trade deficits in 1983 and projected for 1984 alone equal the total of all other U.S. trade deficits since the Colonial era.

There are a number of reasons why the U.S. foreign sector will not show improvement this year and in 1985 unless the deficit-bloated dollar shrinks substantially. First, economic growth in the United States will exceed growth in both Japan and Europe, adding to the U.S. import flood. The International Monetary Fund, for example, is projecting a 1.7 percent real GNP increase in West Germany during 1984 and 3.5 percent in Japan -- nearly two percentage points below the expected U.S. growth rate. Second, despite some wage concessions, U.S. firms have not been noticeably successful in trimming production costs to meet lower priced imports. U.S. goods and services continue to be substantially overpriced compared to foreign goods. Third, the dollar has remained surprisingly resilient on foreign exchange markets. While declining 6-7.5 percent in value since January, the deficit-bloated dollar has not collapsed despite a sagging domestic stock market and staggering budget deficit projections. Finally, as noted above, the U.S. trade deficit typically deteriorates as recoveries mature. Domestic firms turn away from foreign markets to sell in growing home areas, and foreign firms become more aggressive in selling here, especially if their own economic recoveries lag the U.S. recovery. Taken together, these factors led the Administration to project more than a \$100 billion trade deficit for 1984 and a \$70 billion net foreign capital inflow. Other projections go higher.

Underlying the sharp decline in the U.S. trade position is the striking price disadvantage confronting U.S. exporters and import-competing firms. Since 1979, for example, U.S. electrical machinery exports have risen 26 percent in price against competing Japanese and German products. The price of non-electrical U.S. machinery exports has jumped 33 percent, and U.S. transport equipment export prices are up 39 percent. As prices rose, export sales dropped. Between 1981 and 1984, for example, U.S. exports fell 13 percent or \$37 billion.

The looming Federal deficits will worsen this picture of a foreign sector depression in the midst of a domestic boom. With deficit-driven

real interest rates rising, the dollar is projected to decline less than 10 percent on foreign exchange markets over the next five years. Imports are projected to grow a startling 13 percent annually during the period 1984-1989, and the U.S. net export position will continue deteriorating. The net export position is the net of U.S. merchandise and service imports and exports. It reflects both the price competitiveness of U.S. goods and services in world markets and the stage of business cycles here and abroad. Like the merchandise trade balance, this indicator should have shown improvement as the economy recovered last year. Yet, it deteriorated sharply in 1983 instead, declining to a deficit of \$7.1 billion from a surplus of over \$17 billion in 1982. The impact of the budget deficits on the dollar in foreign exchange markets simply overwhelmed conventional cyclical factors influencing U.S. trade patterns.

That phenomenon is projected to continue. Indeed, by 1989, if the budget deficits are left unattended, the reeling foreign trade sector will be a much larger brake on economic growth than it is today. The U.S. net export deficit is projected to climb steadily and reach an enormous \$95 billion by then. The Department of Commerce estimates that each additional \$30,000 in merchandise exports produces one new job. If a comparable relationship exists for service sector exports, the 1983 net export deficit due to the budget deficit cost the U.S. over 200,000 jobs. By 1989, if left unattended, the budget deficit's impact on foreign sector employment will soar and cost the U.S. 3 million jobs. That job loss will come in addition to the 1,200,000 jobs already lost in merchandise export and basic industries since 1982.

Savings Versus Consumption:

The unbalanced nature of the ongoing recovery will impose lopsided burdens on the housing and foreign trade sectors in the near and intermediate term. In the longer term, however, the simulations conducted for this analysis found that productivity will be seriously debilitated by the deficits, as well. The deficits are projected to act as a brake on future economic expansion and U.S. competitiveness in world markets by crippling savings and productivity-oriented investment. Moreover, the looming Federal deficits through 1989 will eliminate any gains in savings or investment which may have accrued from the Reagan Administration's economic program implemented in 1981. As Dr. Feldstein noted in testimony before the Joint Economic Committee on November 8, 1983, "The primary effect of large budget deficits is clearly to absorb savings and therefore to reduce the rate of capital accumulation and the potential rate of economic growth."

The diversion of scarce national savings to finance the ever-growing projected Federal deficit reflects an implicit national decision to favor current consumption over savings. Rather than permitting scarce domestic savings to be available for new and more productive plant and equipment investment, the Treasury will preempt a hefty and growing share of such savings to finance deficits -- the bulk of which is promptly converted to consumption spending. This conversion of scarce national savings to current consumption by Federal deficits will continue to grow inexorably in

magnitude, reaching a projected \$306 billion by 1989. These deficits will become increasingly structural in nature, composed largely of interest payments on the burgeoning national debt. They are already of such magnitude that net interest outlays this year will be nearly double the entire Federal deficit for any year prior to 1982. And they are projected to climb over 14 percent annually if no steps are taken to reduce the deficit. This massive diversion of savings to consumption will accelerate in line with rising net interest payments for the balance of the decade. It will occur regardless of interest rate levels and is unaffected by any crowding-out phenomenon.

The impact of this diversion of scarce national savings to consumption by the deficits is largely ignored in the current deficit debate. In part, this reflects the reality that the debilitating impact on savings and investment of deficits is largely hidden and incremental in nature. Moreover, while the impact of deficits on housing or exports is straightforward, their impact on savings and investment is less clearly defined. In addition, these effects are not immediate; they erode a nation's economic structure and output only over an extended period of years.

Supply Side Effects of the Economic Recovery and Tax Act:

The Reagan Administration rode a crest of rising Congressional awareness with the productivity issue to success in gaining passage in 1981 of the Economic Recovery and Tax Act (ERTA). By the late 1970's, sufficient documentation had accumulated to demonstrate that U.S. investment and productivity growth was lagging well behind that of international competitors such as Japan and West Germany. These differences transcended cyclical fluctuations. They had reduced U.S. flexibility to ease unemployment and absorb rising nominal incomes without an increase in the pace of inflation. Indicators of savings and investment displayed a mixed picture. But, few analysts now doubt that U.S. investment levels were inadequate to match the sharp rise in labor force growth experienced in the last decade.

Major components of ERTA were designed to enlarge the after-tax return for savings and investment at the expense of consumption. The beneficial effect of these incentives until recently has been negated by the cyclical impact of the recession. Only now can such benefits conceivably be claimed. For example, real capital spending is projected in 1984 to rise for the first time since 1981. Even so, a good portion of that increase is the result of cyclical factors, not ERTA. Productivity was suppressed, as well, by the recession. It declined slightly in 1982 for the third time in four years. The recovering economy pulled productivity in the nonfarm business sector up 3.1 percent for all of 1983, however, despite tailing off badly in the fourth quarter.

The conversion of scarce savings to consumption by the Federal deficits through the balance of this decade will wipe out any imagined or real boost to savings, investment or productivity from ERTA. Indeed, by creating a sizeable mismatch between Federal outlays and receipts, ERTA must shoulder

much of the responsibility for the deficit outlook and for its related failure to stimulate the economy's supply side. With hindsight, ERTA can be viewed as excessively consumption oriented. Its savings and investment-oriented components were overwhelmed by the needlessly large pump-priming consumption components.

The simulations evaluating the impact through 1989 of Federal deficits due to ERTA reveal that they will cripple savings, investment and productivity growth. Individual savings rates will be depressed below even recent historically low levels. The conversion of massive amounts of savings to consumption by the deficit-financing mechanism will squeeze U.S. investment below the rate maintained even in the sputtering 1970's. Moreover, productivity will decline and remain low throughout the balance of the decade under the twin pressures of lagging private investment and sluggish growth. By 1989, the decade of the Eighties will be viewed as a once in a lifetime spendthrift binge on borrowed credit, with growing debts accumulated at the expense of a sharply deteriorating national economic base.

Savings:

As depicted in Table IV, U.S. savings has historically lagged behind other major industrial nations. Indeed, the U.S. devotes a smaller share of national output to savings than any other major industrial country. At the other end of the spectrum, for example, about one in every three dollars of Gross Domestic Product (GDP) in Japan has historically been withheld from current consumption and made available as savings for investment in new production facilities, equipment and housing. The U.S. has traditionally saved less than one in five dollars of GDP.

Table IV

Gross Saving as Share of Gross Domestic Product (%)

	1962	1970	1978	1982
United States	18.9	18.1	20.3	15.9
Japan	34.8	40.2	32.3	31.6
Germany	27.3	28.1	22.8	21.5
France	24.6	26.2	22.6	18.5
United Kingdom	16.9	21.5	19.4	16.9
Italy	26.0	24.2	22.4	18.8
Canada	20.8	21.1	20.1	18.0

Source: OECD Economic Outlook.

Critical to the maintenance of even this relatively low savings rate was the tendency of individuals to save around 7 percent of their disposable income. From 1951 to 1981, for example, an average 6.9 percent of such income was saved, as shown in Table V. Only in recession years like 1982 did the rate drop sharply as individuals struggled to maintain living standards. Even during the latter half of the 1970's as inflation eroded savings incentives, individuals nearly maintained their historic savings rate. The simulations conducted for this analysis found that the projected rate of individual savings will fall below historic recession levels into the foreseeable future if budget deficits are left unattended. On average as a share of personal disposable income, the individual savings rate is projected to fall over 20 percent to 5.4 percent of disposable income over the period 1984 to 1989 from the postwar average rate of 6.9 percent.

Table V
Savings Rate
1951-1989

<u>Period</u>	<u>Savings 1/</u>
1951-1960	6.8
1961-1970	6.8
1971-1980	7.1
1970-1974	7.9
1975-1981	6.6
1951-1981	6.9
1982	5.8
Simulation (1984-1989)	5.4

1/ Individual Savings as a Share of Personal Disposable Income (percent).

Source: Economic Report of the President, February, 1984.

Investment:

The historically lagging U.S. savings experience is paralleled by relatively low investment levels. The United States invests a smaller share of its national output than its major trading partners. As noted in Table VI, for example, the five other largest OECD nations devoted a larger share of GDP during the last decade to investments in plant, equipment, inventories and housing. Indeed, Japan invested a 75 percent larger share of GDP than did the U.S.

Table VI
 Capital Formation in Major OECD Countries
 1971-1980

Country	Investment as percent of GDP		Growth Rate of output per hour in manu- facturing
	Gross investment	Gross fixed investment ^{1/}	
France	24.2	22.9	4.8
Germany	23.7	22.8	4.9
Italy	22.4	20.1	4.9
Japan	34.0	32.9	7.4
United Kingdom	19.2	18.7	2.9
United States	19.1	18.4	2.5

^{1/} Gross investment less inventories.

Source: Organization for Economic Cooperation and Development and
Economic Report of the President, February, 1983, p. 81.

Investment in new, more efficient plant and equipment is one of the major factors forcefully and directly influencing productivity growth. The lagging U.S. productivity performance in manufacturing during the last decade noted in Table VI reflects the poor U.S. record of such investment. Particularly in the latter half of the 1970's, limp U.S. investment rates barely kept pace with labor force growth. During the 1950's, for example, net capital stock per U.S. worker rose an average 3.3 percent annually. In the 1960's, it averaged 3.2 percent. Yet, from 1971 to 1975, it slumped to a 2.2 percent annual growth rate. And from 1976 to 1980, it collapsed, rising a scant 0.4 percent annually. U.S. productivity reflected that sluggish investment performance almost immediately. With only marginally more capital per worker available year after year, U.S. productivity growth shrank. Indeed, it actually declined in three of the four years beginning in 1979, before rebounding in its usual pattern last year during the recovery.

U.S. investment outlays devoted to plant and equipment (nonresidential fixed investment) comprise slightly over fifty-five percent of all gross U.S. investment. As noted in Table VII, they averaged 11.7 percent of GNP from 1978 to 1982 when our productivity collapse occurred. Simulations conducted for this analysis project that the prospective deficits will force vital U.S. investment spending on key plant and equipment below even the inadequate levels maintained then. They will slump to a projected 11.4 percent of GNP from 1983 to 1988.

Table VII

Gross Private U.S. Nonresidential Fixed
(Plant and Equipment) Investment
1978-1988

<u>Year</u>	<u>Share of GNP (%)</u>
1978	11.5
1979	12.0
1980	11.7
1981	11.8
1982	11.3
1978-82 Simulation	11.7
(1983-88)	11.4

Source: Economic Report of the President, February, 1984 and
Joint Economic Committee Simulations.

The decline in U.S. investment activity due to the looming deficits appears modest. Yet, the cumulative impact by the end of this decade will be enormous. For example, by 1989, the U.S. will have spent \$59 billion less on vital new plant and equipment than had such outlays at least matched the average GNP share of such outlays in recent years. The impact of this modest decline in an already weak investment picture is reflected in projected productivity figures.

Productivity:

Productivity is the fulcrum upon which rising living standards hinge. There is a broad and on-going debate among analysts regarding the major determinants of productivity growth. A bewildering variety of factors influence productivity, including labor force growth, labor force age, training, attitude and composition, government regulations, the business cycle, international exchange rates, the level of input prices like energy or capital, R&D spending and results, incentives for entrepreneurial activity, technical innovation and dissemination, the degree of competition, management incentives and capability and others. Investment is among the more important determinants and may be the single most important factor. Certainly the failure of plant and equipment investment to offset labor force changes, government regulations and the impact of rising energy prices is a dominant factor in the recent U.S. productivity slump. In addition to lending an inflationary bias, lagging productivity inevitably yields a smaller increase in real per capita income. Indeed,

increases in any society's real per capita GNP over time come from an improved net real export position or increasing productivity. By crippling both U.S. trade and productivity growth, Federal deficits will have a major enduring negative impact on national income growth in the United States for many years to come.

U.S. productivity growth has lagged productivity growth in our major trading competitors since World War II. As presented in Table VIII, U.S. productivity has grown only one-fourth as fast as Japanese productivity since 1950, for example. Moreover, the trend of U.S. productivity growth in the postwar period has been a declining one. From 1950 to 1965, real U.S. GDP per worker grew an average 2.4 percent annually. That growth rate eased to an average 1.6 percent annually from 1965 to 1973 before plunging to less than one-half of one percent annually over the 1973-1978 period.

Table VIII

Productivity Measures for Various Countries
1950-1978

	<u>Average annual percentage change in productivity^{1/}</u>			
	<u>1950-65</u>	<u>1965-73</u>	<u>1973-78</u>	<u>1950-78</u>
Japan	7.2	9.1	3.1	7.0
West Germany	5.2	4.3	3.2	4.6
Italy	5.1	5.6	1.3	4.5
France	4.7	4.5	2.8	4.3
Canada	2.7	2.3	.8	2.3
United Kingdom	2.2	3.3	.9	2.3
United States	2.4	1.6	.4	1.8

^{1/} Measured by growth in real domestic product per employed person, using own country's price weights.

Source: Bureau of Labor Statistics.

A similar pattern is found using the more closely followed indicator of nonfarm business sector output per hour. As displayed in Table IX, U.S. average annual productivity growth has stagnated in recent years, after averaging above two percent during the 1950's and 1960's. Productivity jumped during 1983 in the typical pattern for postwar recoveries. Even so, the 1983 performance raised more questions about the future U.S. productivity trend than it put to rest. The 1983 gain of 3.1 percent in the nonfarm business sector is a limited one, well below the 4.9 percent rate averaged during the first year of all other postwar economic recoveries. Moreover, the already high and projected rising level of real interest rates due to growing deficits threatens to sharply limit the current recovery in productivity. After climbing at an annual rate of 7.1 percent in 1983:2; for example, output per hour rose at much smaller rates of 2.3 percent and .9 percent in 1983:3 and 1983:4.

Table IX
U.S. Productivity Growth
1950-1989

<u>Period</u>	<u>Growth in Output per hour (all persons) 1/</u>
1950-1960	2.3
1961-1970	2.4
1971-1977	2.0
1978-1982	0.0
1983	3.1
Simulation, 1985-1989;	1.8

1/ Annual average (%), Nonfarm Business Sector.

Source: Economic Report of the President, February, 1984,
Economic Indicators, Council of Economic Advisers
(various months) and Joint Economic Committee Simulations.

As sensitivity to the productivity peril posed by Federal deficits has grown, even projections by the Administration of future productivity growth have been scaled back. In the January, 1982 Economic Report of the President, for example, the Council of Economic Advisers projected a handsome 2.6 percent annual productivity increase for the economy through 1988. Yet, the most recent February, 1984 Economic Report of the President reduced that projection quite sharply to 1 percent or less by 1988 in light of the burgeoning budget deficits.

The outlook for U.S. productivity created by the enormous prospective budget deficits has received scant attention. Yet, the increasing diversion of national savings to finance the deficits are projected to have a direct and major negative impact on future productivity. In turn, that will have a marked impact on U.S. economic competitiveness, GNP and income. By slashing savings flows, slowing growth, and raising real interest rates, the deficits are projected to suppress future productivity growth below historic levels. Indeed, it will be pushed down even below the weak levels maintained for most of the last decade. The simulations conducted for this analysis project that U.S. nonfarm business sector productivity will grow only an average 1.8 percent per year from 1985 to 1989. This rate is a scant 75 percent of the productivity growth rate attained from 1950 to 1970 noted in Table IX. It compares favorably only with the disastrous 1978-1982 period when no productivity growth occurred.

The future for America under the weak projected 1.8 percent annual productivity growth rate compares poorly with a future featuring the 2.35 percent rate attained from 1950 to 1970. For example, by 1994, U.S. productivity will be 5.7 percent less if growth at the lower projected rate occurs instead of at the historic 2.35 percent average rate. The lower productivity growth rate will reduce nominal GNP a decade hence by a projected \$500 billion -- or a loss of output equal to \$2,000 in 1994 for every man, woman and child.

CHAPTER II

Economic Impact of the Administration Deficit Reduction Proposal

In mid-March, the Administration presented a revised budget proposal containing a \$150 billion nominal reduction in the FY85-87 deficits. This chapter evaluates the economic impact of that proposal through 1989. It concludes with a brief evaluation of the impact of a larger deficit reduction package, as well.

Deficit Reduction and Slower Growth:

As the simulations discussed in Chapter I make clear, inaction on the budget deficit will reduce the historic share of U.S. resources being withheld from consumption and devoted to investment. Future growth and investment will be sluggish. The economy for the balance of the decade will compare unfavorably even with the mediocre 1970's.

White House and congressional action to reduce future deficits may not redress this consumption bias and improve future growth and living standard prospects. By increasing taxes and reducing government spending, deficit-reduction plans create fiscal drag which will magnify the projected economic slowdown. This slowdown can be avoided by deficit reduction packages which substantially reduce the deficits, thereby easing credit markets and lowering interest rates promptly. The major risk is that a deficit-reduction package will not lower interest rates sufficiently to avoid an economic slowdown. By attacking deficits meekly, modest proposals may simply slow economic growth while their small size proves inadequate to reverse the rising deficit trend. The magnitude of the Administration's March proposal falls into this category.

The econometric simulations utilized here are modifications of the DRI current services budget baseline. The Administration's March proposal was presented in terms of the February budget proposal, rather than on a current services budget basis. Restating the March proposal on a current services budget basis resulted in three modifications. First, it was necessary to recast the proposed Administration defense outlays reductions covering Fiscal Years 1985-1987. The Administration's February budget proposal projected defense outlays over FY85-FY87 of \$931 billion, as noted in Table X. The Administration's March proposal reviewed here reduced that spending stream by \$40 billion to \$891 billion. However, the DRI simulations utilized in this analysis are on a current services budget baseline, not the February Administration proposed spending levels. Compared to the CBO current services budget baseline, the Administration's March defense outlay stream over FY85-FY87 is slightly higher (by \$4 billion), not lower by \$40 billion.

The second necessary modification was to adjust Federal debt service outlays to reflect the Administration's deficit reduction proposal. Initially, the Administration claimed savings of \$18 billion over FY85-87. The recasting of defense outlays reduces this savings to \$12 billion on a current services basis. Thus, the total nominal deficit-reduction package

proposed in March on a current services budget basis totals \$100 billion, not \$150 billion. In evaluating the March Administration proposal, therefore, a nominal deficit reduction package of \$100 billion was utilized for compatibility with the simulations conducted for this analysis.

Table X

National Defense Outlays
Fiscal 1985-1987
(Billions of Dollars)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>Total</u>
Current Services, CBO Baseline ^{1/}	263	295	329	887
Administration February Proposal	272	311	348	931
Administration March Proposal	266	295	330	891
Defense Reduction:				
Compared to CBO Baseline	+3	-0-	+1	+4
Compared to February Proposal:	-6	-16	-18	-40

^{1/} Assumes five percent real increase in outlays annually.

Sources: CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1985" (February, 1984); Administration Fact Sheet for March \$150 Billion Downpayment (March, 1984).

Administration Economic Assumptions:

The third modification was to eschew use of the Administration's economic assumptions and projections in evaluating its March proposal. The Administration's FY85 budget submissions in February contained both economic and budget projections covering the period 1984 to 1989. The economic outlook projected by these variables is rosy. While only a token effort to reduce deficits is proposed, the variables nevertheless depict an economy enjoying 4 percent annual real growth accompanied by gradually easing unemployment. The GNP price deflator is projected settling to a scant 3.5 percent by 1989. Moreover, the 91-day T-bill rate is presumed to subside along with inflation, falling over 30 percent to 5.0 percent by 1989 from an average 8.6 percent last year.

While the 1984 and 1985 economic variables are considered forecasts in the budget documents, out-year variables are assumptions. These assumptions bear no explicit relationship to actual or proposed Administration economic policy, nor are they the fruit of econometric

simulations. The particular values are said by the Administration to reflect historical experience, even though current deficits are without historic precedent. Consequently, they represent little more than subjective and arbitrary point estimates designed to depict the future in a particular economic light.

Despite their capricious nature, these variables form the foundation for the Administration deficit projections presented in the Fiscal Year 1985 budget and March deficit reduction proposal. The Administration's March proposal is a package of spending reductions, reduced debt service interest costs and tax increases. When compared to current services budget estimates, it has already been noted that the package yields a nominal \$100 billion reduction in the projected FY85-87 current services budget deficit. This represents a reduction of about 14 percent in the projected status quo current services \$707 billion deficit over that three-year period. Based on its rosy economic assumptions, this package is said by the Administration to result in sharply smaller deficits as the decade matures.

That assertion is incorrect and the underlying optimistic deficit projections are flawed for two reasons.

First, as just noted, the deficit projections are based on artfully rosy economic assumptions without empirical or theoretical foundation. These assumptions do not reflect a likely or even a reasonable scenario for the balance of this decade in light of the prospective deficits. Nor are they the result of deliberate and careful econometric analyses. Indeed, they are at variance with all forecasts of such variables, including the results noted in Chapter I, and the consensus Blue Chip Economic Indicators. As noted in Table XI, for example, a recent Blue Chip Economic Indicators survey contained a consensus estimate that real GNP would grow 1.7 percent in 1986. The Administration estimate for 1986 was 4 percent, or 130 percent faster.

Second, the methodology utilized in projecting the magnitude of future deficits is specious. The Administration's FY85 budget document notes that:

Budget receipts and outlays depend directly on the level of economic activity, inflation, interest rates, unemployment, and other economic factors. Likewise, both budget outlays and the tax structure have substantial effects on the state of the economy -- output, employment, and interest rates.^{1/}

^{1/} Budget in Brief, Fiscal Year 1985 Federal Budget, p.12.

Table XI

Administration and Consensus Blue Chip
Economic Projections
1986-1987

	<u>1986</u>	<u>1987</u>
<u>Real GNP Growth (%)</u>		
Administration:	4.0	4.0
Blue Chip:	1.7	3.2
<u>Consumer Price Index (%)</u>		
Administration:	4.5	4.2
Blue Chip:	6.5	5.7
<u>Short-Term Interest Rate (%) 1/</u>		
Administration:	7.1	6.2
Blue Chip:	9.2	8.5
<u>Long-Term Interest Rate (%) 2/</u>		
Administration:	8.6	7.2
Blue Chip:	10.9	10.2
<u>Corporate Profit Growth (%)</u>		
Administration:	8.9	11.6
Blue Chip:	2.8	9.6

1/ 3-month Treasury Bills.

2/ 10-Year Treasury Notes.

Sources: Economic Report of the President, February, 1984,
and Blue Chip Economic Indicators (March 10, 1984).

The relationship between budgets and the economy is indeed a two-way interaction. Yet, the Administration's deficit projections blandly assume it is but a one-way street. Economic variables such as interest rates affect the budget, but budget deficits do affect these same economic variables. The budget projects economic variables through 1989 in static terms without reference to the dynamic impact on them of relevant Federal budgets. The variables, especially interest rates, simply do not reflect the impact of the enormous looming deficits.

The resulting set of Administration budget projections, economic forecasts and assumptions are of little use in assessing economic policy.

Of more significance for this analysis, they are useless as a baseline for evaluating the economic impact of prospective Federal deficits. Instead, the DRI annual econometric model using the current services budget baseline was utilized to evaluate the deficit's impact on savings, investment and productivity through 1989.

Administration Program Simulation:

Adjustments in the timing of the Administration's March proposal were made to reflect the calendar year basis of the DRI model. An M1 growth rate in the top half of the Federal Reserve Board's 83:4-84:4 target range was assumed to persist through 1989.

The Administration's budget projected robust growth accompanied by falling interest rates and low inflation for the balance of this decade. That would represent a noteworthy improvement over the projected economic impact, reviewed in Chapter I, should no steps be taken to reduce the deficit. However, the Administration's economic scenario through 1989 could not be confirmed nor even replicated using the DRI annual econometric model. Instead, the simulations evaluating the March proposal projected a continued robust recovery this year with real GNP rising over 5 percent, compared to 3.3 percent in 1983. However, rising interest rates this year and continuing high interest rates in the future are projected to yield sharply lower economic growth after 1985. Indeed, as summarized in Table XII, the economy is projected to fare little better under the Administration's proposal than it would should no action at all occur to ease the rising deficit trend for the balance of the decade. Real growth is projected to be virtually the same, for example, because the Administration's proposal is too meek to substantially ease interest rates or relieve the sagging foreign trade sector.

Table XII
Economic Indicators
1985-1989

	<u>1985-1989 Annual Average</u>
Economic Growth (%)	
No Action	3.3
Administration March proposal	3.3
Unemployment Rate (1989 average) (%)	
No Action	7.0
Administration March proposal	6.9
Gross Nonresidential Investment (billion dollars)	
No Action	594
Administration March proposal	608
Gross Nonresidential Fixed Investment (billion dollars)	
No Action	551
Administration March proposal	565

Source: Joint Economic Committee Simulations.

Savings and Investment:

The economic simulations of the Administration's March proposal found that it will only marginally improve the U.S. investment outlook expected if no action is taken to reduce deficits through 1989. The combination of high real interest rates and sluggish GNP will limit gross private nonresidential investment growth. As shown in Table XII, such investment outlays by business will only average \$14 billion more annually over 1985-1989 than they would if no steps are taken to reduce the deficits. And, key gross plant and equipment (nonresidential fixed) investment under the Administration's program averages only \$14 billion higher than if the deficits are left unattended. That weak investment prospect in productivity-enhancing plant and equipment is magnified by comparison to the patterns of gross private nonresidential fixed investment which existed during the 1970's and early 1980's investment crunch. As a share of GNP, gross investment in new plant and equipment averaged 11.7 percent during that sluggish period, as noted in Chapter I. The economic simulations evaluating the impact of the Administration's March proposal indicate that it will not improve on this mediocre record.

The impact on savings of the Administration's March proposal is less than robust, as well. As noted in Table XIII, the personal savings rate is

projected to average 5.3 percent of disposable personal income for 1985-1989, well below the post-war average. The savings rate projected to occur with the Administration's March proposal is slightly less than projected should no action be taken of any type to reduce deficits, as well. This lower savings rate will severely limit the flow of investable funds to capital markets through 1989, and is the mirror image of the weak investment outlook. The projected savings rate of 5.3 is 1.6 percentage points below the post-war individual savings rate. Over the period 1985 to 1989, this 1.6 percentage point difference will produce \$260 billion less in personal savings than had the historic rate been maintained. That foregone savings is nearly twice the total annual current level of personal savings.

Table XIII
Savings and Productivity
1961-1989

	<u>Rate</u>
<u>Savings 1/</u>	
1961-1970	6.8
1971-1980	7.1
1951-1981	6.9
Administration Proposal Simulation (1985-1989)	5.3
No Action Simulation (1984-1989)	5.4
<u>Productivity 2/</u>	
1961-1970	2.4
1971-1977	2.0
Administration Proposal Simulation (1985-1989)	1.8
No Action Simulation (1985-1989)	1.8

1/ As share of personal disposable income (%).

2/ Growth in output per hour nonfarm business sector (%).

Source: Economic Report of the President, February, 1984,
and Joint Economic Committee Simulations.

Productivity and the Deficit:

The projected productivity performance generated by the Administration's March proposal is weak. Weakening growth and the continuation of interest rates at high levels through 1989 will limit U.S. productivity growth. Indeed, the simulations project that it will average a meek 1.8 percent a year from 1985 to 1989. That projection is below the rate maintained during most of the last decade (1971-1977) when productivity growth averaged 2.0 percent annually. And it is well below the 2.4 percent growth averaged during the decade of the 1960's. The Administration's March proposal will not reverse the declining U.S. productivity trend. Moreover, it will produce the same weak productivity performance which is projected to occur if the deficits are simply left unattended by the Administration and Congress. Because of this meek projected productivity performance, GNP and personal income growth under the Administration's March proposal will lag well behind growth rates scored in the 1960's and 1970's. The result of this lagging productivity performance will be smaller output in the future and substantial foregone income. For example, U.S. GNP will be 3.1 percent lower in 1989 than it would be if productivity grew at the 2.4 percent annual rate of the 1960's instead of the lower rate associated with the Administration's proposal. Three and one-tenth percent is small. But, with GNP projected to reach \$5.6 trillion by then, it represents a loss of \$170 billion in national output, or over \$650 for every man, woman and child. And, over the entire 1985-1989 period, the lagging productivity performance will slash GNP by a cumulative \$448 billion -- an enormous national income loss comparable to \$1,700 per person.

The budget outlook is no better. The Administration's March proposal is a reduction in the FY1985-1987 current services baseline deficits of \$100 billion in static terms and \$150 billion compared to the Administration's FY85 budget. Yet, the dynamic impact of continuing high interest rates and slower growth limit this proposal's progress against deficits. The Administration's March deficit proposal will yield lower productivity growth and less savings than attained by this Nation in the previous decade. Government debt-servicing costs will continue their pell-mell upward pace. The result is a deficit standoff as Table XIV notes, with out-year deficits remaining at current levels. The inability of the Administration's March proposal to reverse the deficit trend is magnified by the robust monetary policy utilized in the simulations. As noted earlier, M1 growth over the 1984-1989 period was assumed to average in the top half of the present Federal Reserve Board's M1 target range of 4-8 percent over the 1984-1989 period. The Federal Reserve Board was assumed to passively accommodate the recovery and avoid overt steps to boost interest rates and slow inflation.

Table XIV
 Budget Outlook
 (Billion Dollars)
 1985-1989

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Budget Deficit					
No Action:	209	231	267	282	306
Administration Proposal:	175	173	187	176	176
Net Interest Payment					
No Action:	137	159	184	210	237
Administration Proposal:	127	137	150	161	170

Source: Joint Economic Committee simulations.

A Deficit-Reduction Growth Path

When examined in a dynamic context, the Administration's March deficit-reduction proposal is too modest to reduce federal deficits. The fiscal drag created by this program is not offset by sufficiently lower interest rates due to its small size. Consequently, economic growth and government receipts slow, weakening its nominal impact on the deficits. Government debt service costs continue rising sharply, further weakening progress against the deficits.

This discouraging finding emphasizes that a larger deficit reduction package than proposed in March by the Administration is required to ensure a declining future deficit trend. Indeed, the only certain path to reduced deficits is a larger deficit reduction package accompanied by continuation of the monetary policy pace maintained in 83:3 and 83:4. Without continuation of that moderately growth-oriented monetary policy, all efforts to shrink the deficit will impose excessive fiscal drag and may not improve the deficit outlook.

The critical role of a growth-oriented monetary policy in offsetting the fiscal drag of deficit-reduction proposals is not surprising. ERTA added a net fiscal stimulus to the economy of some \$50 billion in Fiscal Year 1983. Yet, the switch to an expansionary monetary policy in mid-1982 played the key role in generating the 1983-1984 recovery. Indeed, the present expansion can aptly be termed a Federal Reserve Recovery. The monetary aggregate M1, for example, soared 13.4 percent from July, 1982 to July, 1983, well over double its prior growth rate. Short-term interest rates fell 33 percent or over four percentage points between July and

October, 1982 as a consequence, and long-term rates fell almost as far. Interest-sensitive industries like housing and autos gradually rebuilt strength and by 83:1, real GNP was rising and the recovery was underway. The Federal Reserve Board reduced the economy's inflationary potential associated with the recovery when it slowed monetary growth in the summer of 1983. That potential has increased in probability since then, due to the surprisingly robust recovery. Thus far, the Federal Reserve Board remains resolved not to monetize the debt and rekindle inflation, although its resolve to permit growth to continue apace may be eroding.

A genuinely declining deficit trend requires a major reversal in fiscal policy and steely Federal Reserve Board resolve to maintain the present moderately expansionary monetary policy. The simulations conducted for this analysis indicate that the requisite fiscal policy is a deficit-reduction package about 50 percent larger than the \$100 billion current services deficit reduction proposed by the Administration in March. Such a fiscal package was evaluated in conjunction with an M1 growth rate in the top half of the Federal Reserve Board's current target range of 4-8 percent (83:4-84:4). The fiscal component of this package represents a \$200 billion nominal deficit reduction compared to the Administration's FY85 budget projections presented in February. This package is comparable in magnitude to that proposed recently by the Senate Democrats and the Joint Economic Committee Democratic Members.

The easing in Treasury credit demands created by this package is projected to reduce real interest rates sharply. By 1989, they will be over 3 percentage points lower than current levels, or those levels projected to exist with the Administration's proposal. This easing of interest rates enables the recovery to continue at a robust pace, and the projected annual real GNP growth rate for the balance of the decade averages 4.1 percent compared to 3.3 percent over the same period under the Administration's proposal. Interest-sensitive industries like housing are projected to do better with this policy combination because of the more robust recovery than if no action on the deficit occurs or under the Administration's proposal. Exports are projected to be higher, as well, than projected in the other simulations and will grow more than 7 percent annually on average after inflation. Moreover, the GNP deflator will rise a projected moderate average 5.5 percent through 1989.

The substantially reoriented Federal posture associated with this policy combination and ensuing continued robust recovery are projected to restore fiscal equilibrium. Tax receipt growth will exceed the growth in net interest outlays. As a result, by 1987, the deficit will be \$100 billion below the level projected for that year should no action occur on the deficit. By 1989, as noted in Table XV, the deficit will be a projected \$32 billion, only half the size of the deficit under the Administration's proposal, and on a clearly downward trend. The cumulative 1985-1989 deficits will shrink by \$593 billion as a result of this policy combination compared to deficits projected over that period if no action is taken to reduce deficits. Moreover, they will be \$185 billion less than projected for the Administration's proposal. And, in combination with the projected lower interest rates, net government interest payments

will be \$241 billion less over the 1985-1989 period than projected in the no-action simulation, and \$59 billion less than projected for the Administration's proposal.

Table XV

Budget Outlook
(Billion Dollars)

	1985	1986	1987	1988	1989
Budget Deficit					
No Action:	209	231	267	282	306
Administration Proposal:	175	173	187	176	176
Deficit Reduction:	170	167	161	122	82
Net Interest Payments					
No Action:	137	159	184	210	237
Administration Proposal:	127	137	150	161	170
Deficit Reduction:	120	130	142	148	146

Source: Joint Economic Committee Simulations.

