

The Economy in Perspective

Fiscal policy in the balance... Earlier this month, President Clinton signed into law two bills that collectively aim to balance the federal budget and slash the public's tax obligations by the year 2002. This legislation caps a long march toward fiscal equilibrium that began—depending on one's partisanship—sometime in the 1980s.

Many people oppose large budget deficits because they believe that fiscal imbalances soak up savings from a limited national pool—savings that would otherwise be directed toward private capital formation. Deficits have also been unpopular because they represent a federal government whose operations have expanded over time yet gone unchecked by any fiscal discipline. Now that the deficit is poised to disappear in a few years, at least some perennial budget critics may be able to sleep more soundly. Others, however, are having bad dreams over the budget deal, and economists are prominent among the insomniacs.

Most economists have long believed that national tax and spending policies affect the economy in two distinct ways: by affecting the overall level of economic activity, and by affecting the allocation of resources at any given level of activity. While most textbooks still claim that major changes in the government's fiscal position can have stimulative or contractionary effects on the level of economic activity, economists are becoming increasingly skeptical about their significance under ordinary circumstances. More and more, the profession is coming to believe that the most important budgetary effects stem from the allocative impact of fiscal policy.

Individual policies create incentives and penalties for engaging in particular kinds of activities. Activities that are heavily taxed are discouraged, while those that are subsidized become more attractive. Federal spending or credit programs also channel more resources in specific directions. Economists refer to these many and varied effects on resource utilization as allocative effects. Governments can induce allocative effects through regulation, without taxing or spending per se. The federal budget

can be in balance at either high or low levels of activity, meaning that the size of the deficit says little about the size of government and its overall allocative impact.

Any set of fiscal policies gives rise to aggregate revenue and spending streams, with the difference indicating whether the government must borrow or retire outstanding debt. These streams include pure transfer programs (like Social Security) as well as direct purchases of goods and services. Deficits require the government to finance its current activities by drawing on the savings of others (through debt issuance)—savings that would have been channeled elsewhere, likely adding to private capital formation.

Fiscal policy changes enacted in 1990 and 1993 laid the foundation for a balanced budget. Indeed, the tax receipts being generated by our currently booming economy have already driven deficits as a share of GDP below 1 percent. Consequently, the 1997 budget plan required less "heavy lifting" than many realize. The macroeconomic effects of this budget plan are not very significant. The allocative effects are an entirely different matter.

The budget legislation contains hundreds of pages, setting forth a host of complex tax credits, deductions, and rate changes, along with spending caps on a variety of federal programs. Each of these changes will affect the public's behavior and lead to a sequence of other consequences. To name just one, college tuition credits will likely encourage more spending on higher education, perhaps boosting tuition for all students. They may also reduce the number of people interested in pursuing skilled trades. The legislation's allocative effects will spread slowly and will play out in complex ways that are now only dimly understood.

Clearly, the new budget package is not a step in the direction of tax simplification for individuals or corporations. Nor does it tackle the impending Social Security or Medicare shortfalls in any substantive way. Here, reform will still have to wait for the political scales to come into balance.