

FOMC Class II

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

Date: July 3, 1995
To: Federal Open Market Committee
From: Randy Mariger
Subject: Corrections and Clarifications to the Greenbook Fiscal Policy Discussion

The staff currently assumes total deficit reduction of \$30 billion in FY1996 and \$55 billion in FY1997, which compares with May Greenbook assumptions of \$20 billion and \$50 billion, respectively. Hence, the incremental deficit reduction in FY1997 fell from \$30 billion in the May Greenbook to \$25 billion in the June Greenbook. The June Greenbook incorrectly implied that the incremental deficit reduction in FY1997 was "unchanged" at \$25 billion.

Also, a close reading of recently passed Congressional Budget Resolution and consultations with Hill staff indicate that earlier press reports concerning the "financing" of the \$245 billion in tax cuts were erroneous. Hence, the Greenbook Part II discussion is misleading.

The Budget Resolution (BR) specifies a two-stage budgeting process. In the first stage, all spending bills are reported out of committee and evaluated by CBO to determine if they meet the requirements of the BR. If the spending bills do not satisfy the BR, then tax cuts cannot be included in the final reconciliation bill. Otherwise, the second stage of the process begins and the tax-writing committees must report out legislation within five

working days that cuts taxes by no more than \$50 billion in FY2002 and \$245 billion over the seven-year budgeting horizon. This tax legislation is then bundled in a reconciliation bill with the spending-cut legislation and submitted to CBO for final certification that it achieves budget balance in FY2002. For this final certification, the BR instructs CBO to include a "fiscal dividend" deriving from lower interest rates and higher GDP growth. CBO has recently estimated that an illustrative path to budget balance in FY2002 would generate a fiscal dividend that amounts to \$170 billion over seven years and \$50 billion in FY2002 (thus, the maximum tax cut of \$50 billion allowed for that year); however, it appears that CBO will have discretion to estimate a new fiscal dividend associated with the specifics of the actual reconciliation package.

The BR specifies that the FY2002 deficit can be no larger than zero. For earlier years, tax cuts, the fiscal dividend, and the associated changes in debt service have not yet been determined. Specific annual deficits, therefore, have not been targeted.

BUDGET RESOLUTION COMPARED TO CBO BASELINE ESTIMATES

	1996	1997	1998	1999	2000	2001	2002	1996- 2002
CBO Baseline Deficit	210	230	232	266	299	316	349	1902
<u>Spending Reductions:</u>								
Discretionary	18	29	40	59	75	99	121	441
Mandatory	20	45	66	90	117	139	168	645
Health	11	25	42	62	82	104	125	451
Other	9	20	24	28	35	35	43	194
Debt Service	1	6	12	20	32	47	67	185
Deficit (reduction from baseline)	39	80	118	169	224	285	356	1271
<u>Maximum Revenue Reductions:</u>								
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	50	245
Memo:								
Preliminary Fiscal Dividend	3	7	14	23	32	41	50	170

Note. The preliminary fiscal dividend is from CBO's April 1995 document *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*.
n.a. Not applicable.