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In This Issue

Balancing Acts in the Outlook . . .

The U.S. economy has been expanding since late 1982, making this the longest peacetime expansion in the 20th century. At the same time, inflation has been remarkably low. Can this pleasant balance of growth and low inflation last much longer?

Maybe, say Preston J. Miller and David E. Runkle in "The U.S. Economy in 1989 and 1990: Walking a Fine Line" (p. 3). Their answer comes mainly from the statistical model that researchers at the Minneapolis Fed have developed and used to generate the national forecasts published in the *Quarterly Review* the last several years. This year the model predicts that in 1989–90 real output will most likely grow at a rate roughly consistent with maintaining high rates of resource use while inflation remains around 4 percent per year. Still, Miller and Runkle warn that this outlook depends a lot on whether or not the Federal Reserve and Congress continue to act responsibly with regard to monetary and budget deficit policies.

. . . In Congress . . .

Since 1985, progress has been made on the budget deficit. In that year, the Congressional Budget Office projected that if the spending and tax policies in place at the time continued, the deficit would approach $250 billion by fiscal 1988. Yet the actual deficit in fiscal 1988 was $155 billion. This progress on the deficit raises two questions: What accounts for the improvement? And will it continue in the future?

These questions are addressed by Preston J. Miller in "Gramm-Rudman-Hollings' Hold on Budget Policy: Losing Its Grip?" (p. 11). His answer to the first is that the progress on the deficit since 1985 is due to the Gramm-Rudman-Hollings (GRH) deficit-reduction act, which mandates automatic spending cuts if deficit-reduction targets are not met and sets a balanced budget as the target for fiscal 1993. His answer to the second is that deficit reduction will continue, but at a reduced rate; previous spending commitments and new pressures to spend will limit future progress.

Miller's second answer implies that future deficits will exceed GRH targets. So, something will have to give: either deficit-reduction actions will be taken or the GRH targets will be avoided. Or, as Miller predicts, policymakers will choose some mix of the two.

. . . And in Theory

Most economists would agree that economic policy choices should be based on an analysis of how the policies affect individual welfare. For taxes that distort an economy's allocation of resources, this means that tax rates should be chosen to equalize the marginal welfare cost of taxation over time. Does a policy of balancing the budget follow from this general principle?

Not necessarily, according to S. Rao Aiyagari in "How Should Taxes Be Set?" (p. 22). The implication of the general principle for the time path of the government budget depends on the characteristics of the economy. Using clear mathematical and diagrammatic techniques, Aiyagari shows that for one special economy the optimal policy is not for the budget to be balanced. Instead, it is for taxes to be constant while the budget deficit fluctuates with government spending. For the same economy, Aiyagari shows that taxes should generally be smoother than spending, increasing the same amount only when the spending increase is known to be permanent.

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