Is Fiscal Policy Driving the Economy (and Fighting the Fed)?

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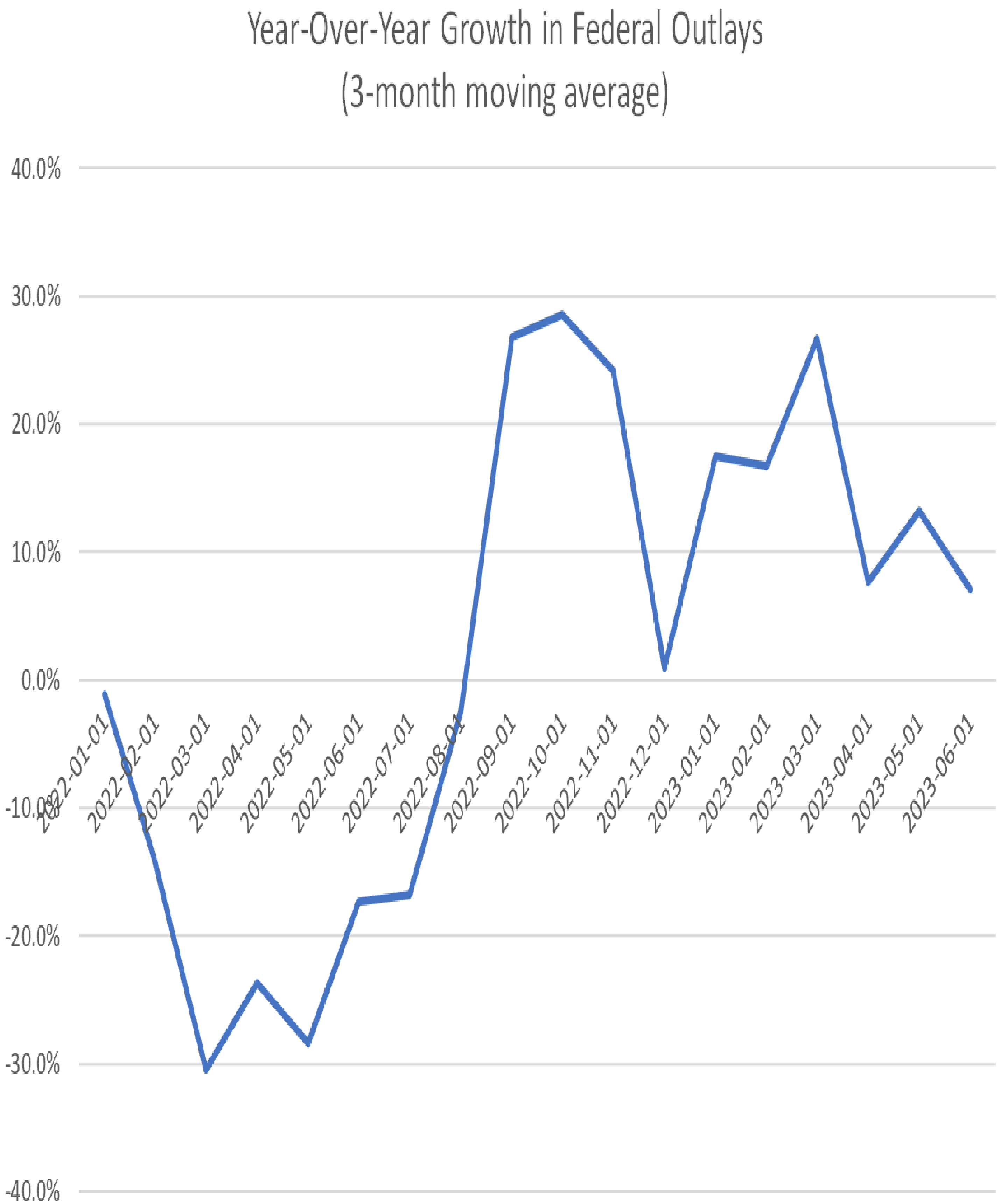
As has been widely noted, the Federal Reserve's anti-inflation campaign has not yet put a serious dent in the pace of economic expansion. Simultaneously, there has been a rising debate over the pace of federal spending. This raises the question: Is federal spending – or fiscal policy more generally – contributing to near-term growth?

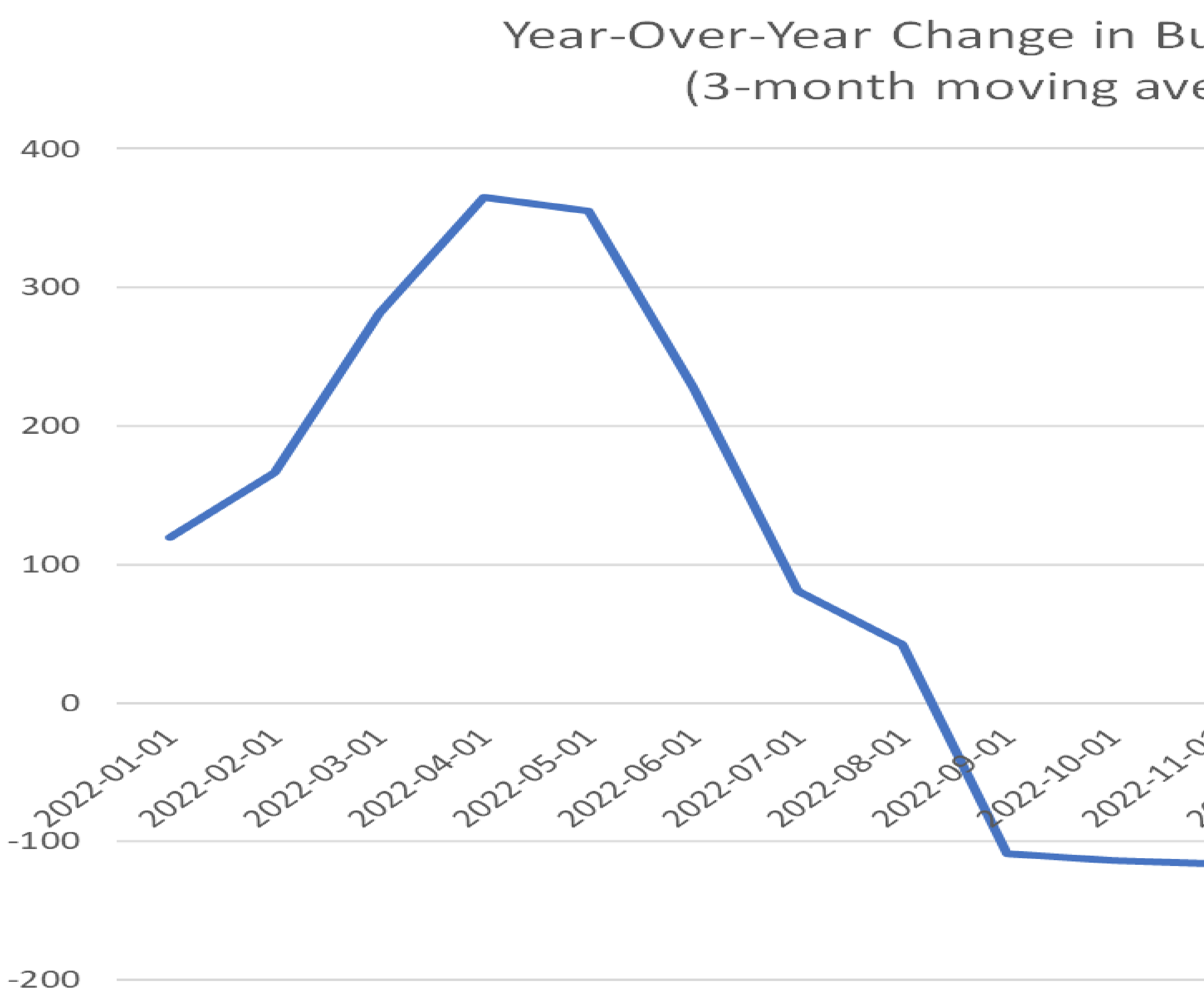
The chart below highlights why some are focused on this issue. It shows year-over-year growth in federal outlays (measured as a three-month moving average) since the start of 2022. The pace of spending growth has swung from a dramatic negative in mid-2022 to rapid rates of growth thus far in 2023. This would seemingly support the "it's the fiscal policy, stupid" version of continued economic growth.


Year-Over-Year Growth in Federal Outlays
(3-month moving average)
40.0%
30.0%
20.0%
10.0%
0.0%
-10.0%
-20.0%
-30.0%
-40.0%
2022-01-01
2022-02-01
2022-03-01
2022-04-01
2022-05-01
2022-06-01
2022-07-01
2022-08-01
2022-09-01
2022-10-01
2022-11-01
2022-12-01
2023-01-01
2023-02-01
2023-03-01
2023-04-01
2023-05-01
2023-06-01

A couple of points, however, are in order. First, this is federal outlays (including transfers) and not federal purchases of goods and services. Thus, it does not directly translate into stimulative demand for goods and services. Second, it is only the spending side of the equation. The impact of fiscal policy on the economy depends as well on the other side of the ledger: taxation.

Indeed, the gold standard for measuring fiscal stimulus in Keynesian economics is the change in the full-employment budget surplus. One uses the deficit as it would be at full employment to control for the fact that, as the economy recovers from recession, taxes increase and spending falls. This "automatic" decrease in the deficit is very different than a deliberate policy decision to raise spending or cut taxes (increase the deficit) or the reverse. And one is interested in the change in the deficit – the additional spending, taxes, etc. – and not the level of the deficit.

The next chart displays the record of year-over-year changes in the budget surplus (measured as a three-month moving average) since the start of 2022. Notice that the unemployment rate had reached 4.0 percent in January 2022, so changes in the budget surplus are essentially changes in the full-employment budget surplus.



Year-Over-Year Change in Budget Surplus (3-month moving average)

This graph tells a story similar to the first. By this crude measure, fiscal policy was sharply negative in mid-2022 and has swung to increasingly stimulative as 2023 has progressed.

But is it quantitatively significant? The final value is roughly $150 billion. In the 2nd quarter of 2023, the economy generated $5,921 billion in gross domestic product (GDP, $23,685 billion at an annual rate), or just below $2,000 billion per month. A $150 billion swing in the deficit is, thus, about 7.5 percent of GDP. Taken at face value, that is real fiscal stimulus. But, again, don't take it at face value – this measure doesn't directly correspond to the demand for goods and services and should be taken with a boulder of salt.

Taken as a whole, the data suggest that there is something to the notion that fiscal policy continues to provide additional demand stimulus that is contrary to the Fed's desired path for aggregate demand. It is another reason Congress should reform the large entitlement spending programs and change the trajectory of federal spending.