III. CREATING A BRIGHT ECONOMIC FUTURE

III. CREATING A BRIGHT ECONOMIC FUTURE

> *There is no doubt that the economic strategy we put in place in 1993 created the conditions for the extraordinary private sector growth we have all witnessed... Four straight years of deficit cuts have produced the economic expansion as well as real benefits for ordinary Americans: lower car payments, lower mortgage rates, lower credit card rates. This balanced budget will close a chapter in American history: years—decades in fact—when our people doubted whether Government could work for them and questioned whether our Nation could set and meet goals.*
>
> President Clinton
> August 1997

For five years, the President has pursued a fiscal and economic policy that has shown remarkable results. Due largely to his 1993 economic plan, the budget deficit, which had hit a record $290 billion in 1992, is not only lower than even the Administration had expected, it's also at its lowest level in a quarter-century. The publicly held debt not only has stopped rising as a share of the economy, but actually has begun to decline. Now, this budget will finish the deficit-cutting job and mark a true milestone in American economic history—the first balanced budget in 30 years.

The President's commitment to lower deficits bore fruit right from the start. Long-term interest rates fell in 1993 and have remained relatively low, helping to spur record levels of business investment. Unemployment and inflation have both continued to fall, bringing the so-called "misery index"[1] to its lowest level in 30 years. The current economic expansion, already the third longest in U.S. history, shows no signs of ending, putting it on track to become the longest in the Nation's history.

Continuing its practice of using conservative economic assumptions, the Administration projects that growth will continue at a steady pace without inflation. Unemployment and interest rates will remain relatively low. Due both to a strong economic outlook and to the 1997 Balanced Budget Act (BBA), the President now proposes a balanced budget for 1999, three years earlier than expected. The economic and fiscal outlook for the longer term, until 2050, also has improved since last year.

Nevertheless, the coming retirement of the baby boom generation points up the need for long-term structural changes that will support the financial health of Social Security and Medicare and ensure that future generations share in the retirement and health security that senior citizens enjoy today.

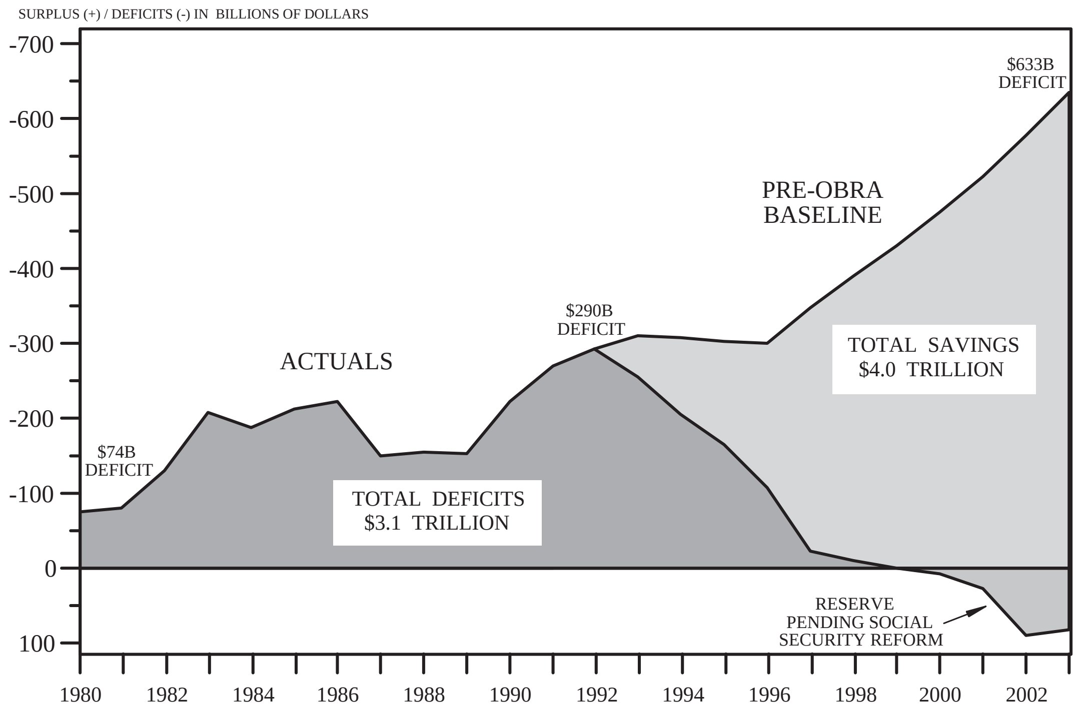
Budgetary Performance

By the time President Clinton took office, the deficit for the previous year, fiscal 1992, had hit a record $290 billion. For the 12 years up to then, annual deficits totaled $2.3 trillion. Never before had the Nation witnessed such an explosion of public debt. Moreover, without changes in policy, public and private forecasters projected that the deficit would keep rising, potentially pushing total public debt, future interest costs, and deficits into an upward spiral without limit (see Chart III–1).

The Administration set out, first and foremost, to cut this massive deficit and to put the budget and economy on a sound,

[1] Over 20 years ago, economist Arthur Okun developed the concept of a "misery index," calculated by adding together the unemployment rate and the rate of inflation, as measured by the Consumer Price Index.

Chart III-1. FINISHING THE JOB: BALANCING THE BUDGET AFTER DECADES OF DEFICITS



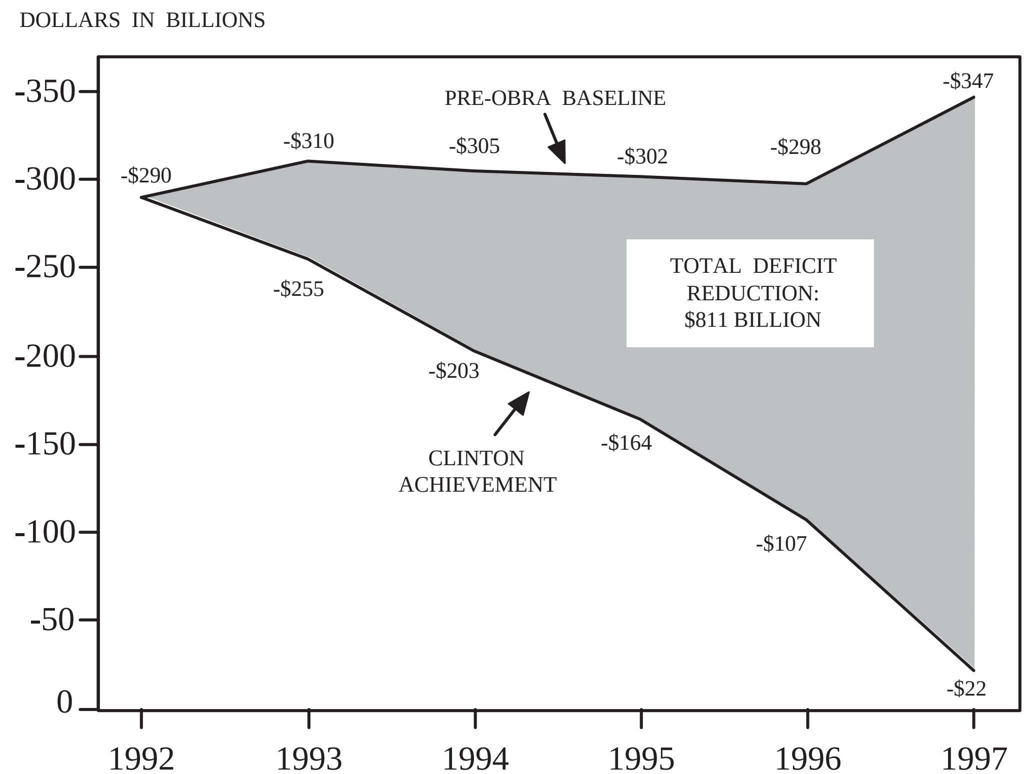
sustainable footing. To that end, the President proposed, and Congress enacted, the Omnibus Budget Reconciliation Act (OBRA) in 1993 as a solid first step toward fiscal responsibility. It has proved to be much more. In the last four years, cumulative deficits and accumulating debt have fallen more than twice as much as the Administration had conservatively projected.

Still, OMB and the Congressional Budget Office (CBO) agreed that the deficit would begin rising again without further action. Consequently, the President worked with Congress to finish the job, enacting the BBA in mid-1997 with the goal of reaching balance in 2002. The Administration now proposes a balanced budget in 1999. In addition, the Administration projects that, together, OBRA and the BBA will reduce the total deficits from 1993 to 2003 by $4.0 trillion—more than the deficits that the Government accumulated from 1981 to 1992.

The Administration has Exceeded Its 1993 Deficit Reduction Pledge: Upon OBRA's enactment, the Administration projected that it would reduce the accumulated deficits from 1994 to 1998 by $505 billion. Clearly, it will exceed that goal. (In fact, in the five years from 1993 to 1997, total deficits are $811 billion lower, as shown in Chart III-2). Each year, the deficit has been lower than the Administration had forecast before the year began. For 1997, the actual deficit of $22 billion was over $150 billion lower than what both OMB and CBO had forecast after OBRA was enacted. All told, the Administration now expects that, combined with a healthy economy, OBRA will reduce the accumulated deficits from 1994 to 1998 by more than twice the projected $505 billion.

The Administration has Ended the Debt Buildup of the 1980s: The Government finances its deficit by borrowing from the public, thereby accumulating its publicly held debt. As a share of Gross Domestic Product (GDP),

Chart III-2. REDUCING THE DEFICIT: THE CLINTON RECORD



Federal debt held by the public[2] reached a post-World War II peak of 109 percent in 1946. Because the economy grew faster than the debt for the next few decades, the debt gradually fell to about 25 percent of GDP in the 1970s. But the exploding deficits of the 1980s sent it back up as a share of GDP. In dollar terms, publicly held Federal debt quadrupled, rising from $710 billion at the end of 1980 to $3.0 trillion by the end of 1992. As a percentage of GDP, it doubled, from about 25 percent to about 50 percent—wiping out all the progress achieved since 1956.

Had this Administration done nothing, the debt would have approached $7 trillion, or 70 percent of GDP, by 2002. Instead, working with Congress, the Administration reversed the debt build-up as a share of GDP, and it now projects that debt will fall below 40 percent of GDP in 2002 (see Chart III–3).

U.S. Budgetary Performance Is Among the World's Best: Counting all levels of government, the total U.S. budget deficit is smaller as a share of GDP than in all other G–7 countries[3] except Canada (see Chart III–4). The reason is not high taxes; the share of GDP devoted to taxes is lower in the United States than in any other leading country. Rather, the reason is relatively low public spending—even though this Nation has a much larger defense establishment than the other G–7 countries.

The Administration has Reduced the Federal Claim on the Economy: By 1992, Federal spending had reached 22.5 percent of GDP, topping its average of 21.2 percent from 1969 to 1997. But, in every budget year under this Administration, spending has equaled a smaller share of GDP than in any year of the

[2] This measure excludes debt held in Federal trust funds. At the end of 1997, the trust funds held over $1.5 trillion of debt that the Federal Government owes to itself. Thus, such debt is both a Government asset and a liability.

[3] The G–7 comprises the world's seven largest industrial powers: the United States, the United Kingdom, Germany, France, Japan, Italy, and Canada.

Chart III-3. DEBT HELD BY THE PUBLIC

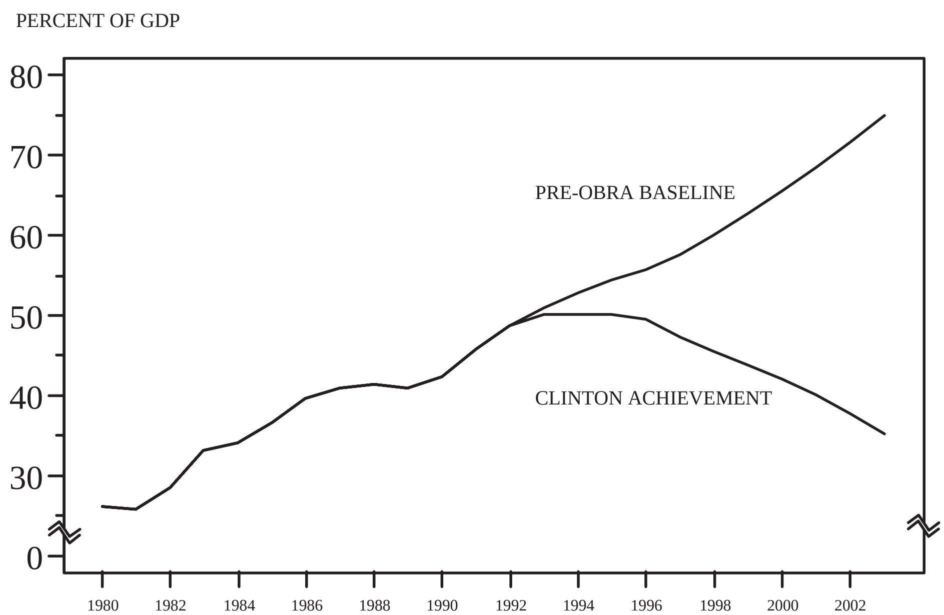
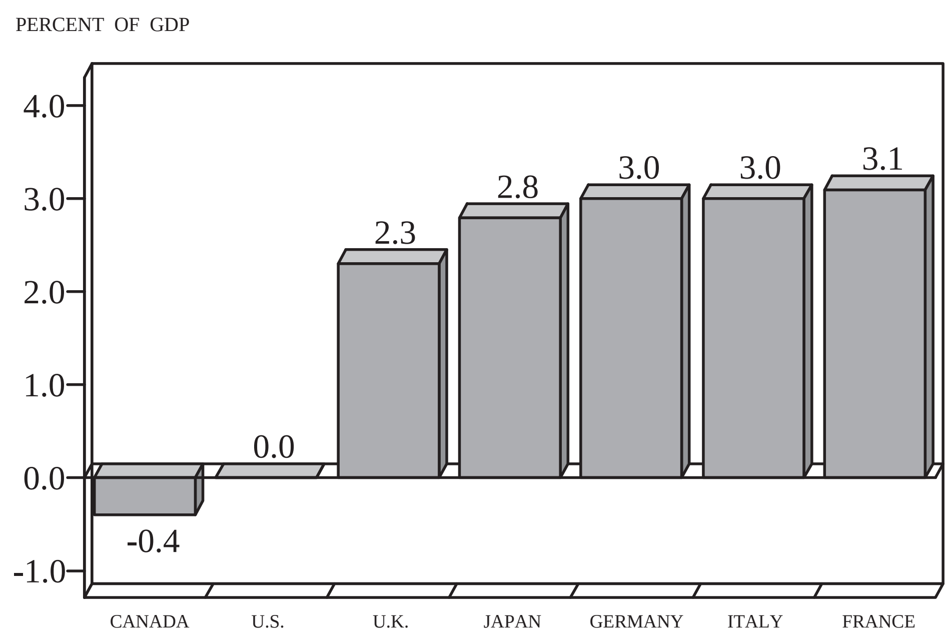


Chart III-4. 1997 GENERAL GOVERNMENT DEFICITS



Source: OECD, Economic Outlook, December 1997.

previous two Administrations. The Administration now projects that, by 1999, spending will fall to 20.0 percent of GDP, its lowest level since the early 1970s.

Federal Receipts are Higher than Projected, Mainly Due to Economic Growth: In the past five years, spending has been lower, and receipts higher, than the Administration had projected, leading to lower deficits than projected. With regard to the most recent, and quite extraordinary, fall in the deficit from $107 billion in 1996 to just $22 billion in 1997, the answer lies in a continuing surge in receipts and in spending that came in below expectations. That surge is rooted in an especially strong economy. Tax rates have remained constant since 1993.

Some economists predicted that the 1993 targeted tax rate increases on the top 1.2 percent of Americans would slow the economy and actually lead to lower tax collections, particularly among the well-to-do. In fact, tax revenues have soared since 1993—and the largest increases have come at the top. Total Federal receipts have risen nearly eight percent a year since 1992. Federal income tax revenues rose by nearly 25 percent from 1992 to 1995 (the last year for which we have data), but by nearly 50 percent for those with incomes above $200,000.

The President's balanced budget for 1999 results from a drop in spending of 2.5 percent of GDP since 1992 and an increase in revenues of 2.3 percent of GDP over the same period, driven by economic growth. Thus, 52 percent of the total deficit reduction has come from spending cuts, 48 percent from higher receipts.

Economic Performance

By reducing the Federal Government's demand for capital in the financial markets, a falling deficit has freed capital for private investment. At the same time, the promise of future budgetary stability has promoted business confidence. The fiscal improvement has enabled the Federal Reserve to maintain low, stable interest rates that, in turn, have helped prolong and strengthen the economic expansion. The surge in business investment of the last five years shows that these policies are working, and as the budget reaches balance, prospects for continued economic progress are excellent.

The Current Expansion Is the Third Longest: In January 1998, the economy recorded its 82nd straight month of growth, marking the third longest expansion in U.S. history (and the second longest in our peacetime history). If the economy continues to grow through the end of 1998, the current expansion will become the longest in peacetime history, surpassing that of the 1980s. If it continues to grow until February 2000, as most private forecasters expect,[4] the expansion will become the longest of all time, surpassing the 106-month expansion of the 1960s.

The Administration's Fiscal Policy Has Promoted a Sound Expansion: Unsustainable Federal deficits, in part, stimulated both of the longer post-war expansions—the first in the 1960s, the second in the 1980s (see Chart III–5). The economy expanded because the Government expanded, dragging the private sector along; when the Government removed its stimulus, the economy faltered.

In these earlier expansions, the fiscal stimulus came at different times. In the 1960s, the deficit was quite restrained early in the decade, but grew sharply after 1965. In the early 1980s, the "structural deficit"[5] soared to almost five percent of GDP. That large deficit helped pull the economy out of the deep recession of 1981–1982, but the Government's subsequent failure to curb it held up real interest rates, led to the financial problems that marked the end of the decade, and helped bring on the recession of 1990–1991.

In contrast, during the current expansion, the deficit has been shrinking and private investment has propelled the economy forward.

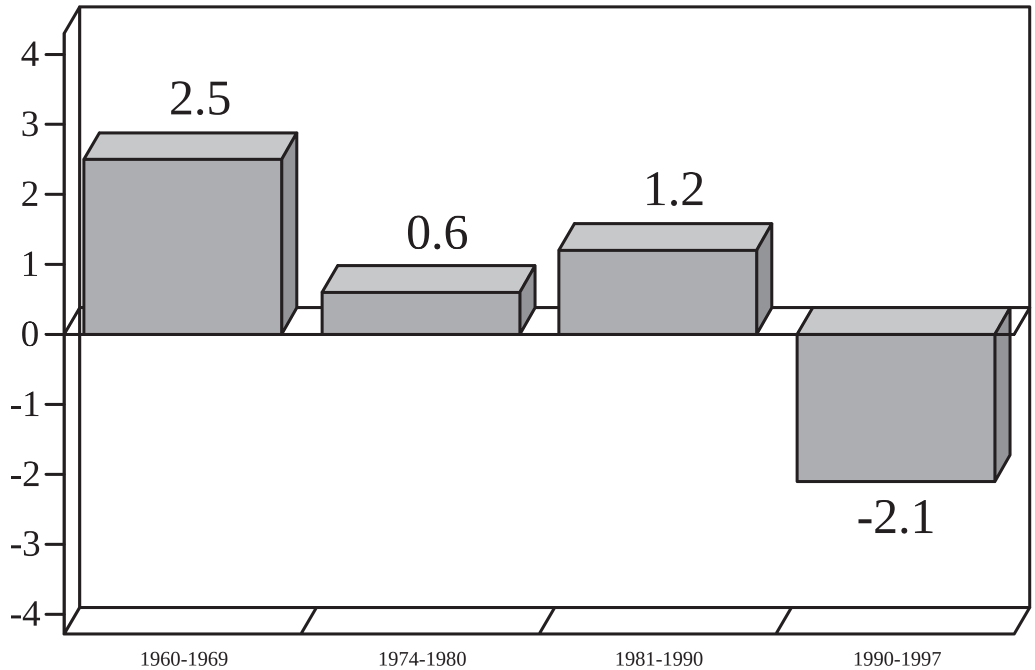
This Expansion is Led by a Strong Private Sector: Under this Administration, the economy has grown at a healthy, inflation-adjusted 3.0 percent a year. But, at least as important, private demand for goods and services has grown even faster than the economy as a whole—3.6 percent a year compared to

[4] According to the December *Blue Chip* survey.

[5] The structural deficit is the deficit that remains after accounting for cyclical changes in the economy as well as purely temporary factors, such as the annual costs and receipts from resolving the thrift crisis.

Chart III-5. CHANGE IN STRUCTURAL DEFICIT AS A PERCENT OF POTENTIAL GDP

(During four longest postwar expansions preceding cyclical peak fiscal year to seventh following fiscal year)



Increase in CBO standardized-employment deficit as a share of potential GDP. Structural deficit is adjusted for deposit insurance, allied contributions to Desert Storm and specturm auctions. Potential GDP is an estimate of a high, standardized level of output over time.

3.0 percent from 1981 to 1989 and 1.3 percent from 1989 to 1993. The Federal Government's direct claim on GDP (mainly, defense and other discretionary spending, excluding transfer payments) has shrunk by 2.6 percent a year. Of the more than 14 million jobs created under this Administration, 93 percent have been in the private sector. In the 1980s, by contrast, the Federal Government's direct claim on GDP grew faster than the private sector's claim.

Why is the contrast important? Because when Federal demands spur economic growth, the economy is more vulnerable to sudden changes in Federal policy—as in the late 1980s when the Government shifted from a defense build-up to a build-down. Though appropriate as the Cold War ended, this shift prompted a painful economic adjustment in many regions. But, when an expansion is led by the investment decisions of thousands of firms and millions of people across the country, the economy is less vulnerable to the sudden swings that can arise from a single policy decision.

A Surge in Business Investment Fueled the Expansion: Since 1992, real business investment in equipment has expanded at an 11.8 percent average yearly rate—more than triple the 3.5 percent annual rate from 1980 through 1992.

Investment growth is important for two reasons:

- Investment adds to the economy's productive capacity, and a larger economy generates more income, leading to higher average living standards. In the final analysis, a stronger economy is a prerequisite to meeting the retirement costs of the baby-boom generation without unduly burdening future workers.
- New equipment embodies advanced technology, making workers who use the equipment more productive. Higher productivity permits larger wage increases without threatening higher inflation.

The "Misery Index" Has Dropped to its Lowest Level in 30 Years: Falling unemployment can "overheat" the economy, leading to higher inflation. In the current expansion, however, both unemployment and inflation have continued to fall, even after the expansion entered its seventh year. In November of last year, unemployment fell to 4.6 percent, its lowest level since 1973. Meanwhile, the core inflation rate (measured by the Consumer Price Index, or CPI, excluding volatile food and energy items), was running at a 2.2 percent annual rate, its lowest since 1966. At the end of 1997, the "misery index"—the sum of inflation and unemployment—was at its lowest level in 30 years (see Chart III–6).

The Near-Term Economic Outlook, 1998–2008

The Administration expects the economy to continue to expand at a healthy rate without inflation. But, growth should moderate from its recent pace. In 1996–1997, real GDP grew at a 3.5 percent average rate, much faster than the economy has been able to sustain in recent decades without higher inflation. Even allowing for somewhat more moderate growth, general macroeconomic conditions would remain very favorable, with both unemployment and inflation remaining near their lowest levels in decades.

Though the economy remains strong, one potentially troublesome development is the financial dislocation in Asia. To maintain growth in the United States and to support stability in Asia, the Administration expects to propose a supplemental appropriation to replenish International Monetary Fund (IMF) resources and, as it did last year, to again propose to provide a contingent credit line to the IMF.

This budget relies on conservative economic assumptions that are close to the consensus among private forecasters, as well as to those of CBO. The Administration is confident that, as the budget reaches balance, the economy could perform even better. Under this Administration, the economy has consistently performed better in virtually all respects

Chart III-6. MISERY INDEX

(Unemployment rate plus inflation rate)

than the Administration or CBO had projected. But, for budget planning, the Administration continues to believe it is prudent to use conservative economic assumptions, the highlights of which include:

Real GDP: Real GDP growth averages 2.0 percent on a fourth-quarter-over-fourth-quarter basis through 2000. For 2001 to 2007, growth averages 2.4 percent a year, the Administration's estimate of potential sustained real growth. Starting in 2008, projected economic growth slows due to the shifting composition of the population. As Americans age, a smaller portion of them will likely be in the workforce. The Administration expects the resulting slowdown in the growth of hours worked to lower real GDP growth.

Unemployment: The civilian unemployment rate rises gradually, from 4.9 percent in 1998 to 5.4 percent in 2001, which is the Administration's conservative estimate of the threshold level of unemployment consistent with stable inflation in the long run.

Inflation: The CPI rises 2.2 percent in 1998–1999, then 2.3 percent a year in the following years. These projections include technical improvements in measuring the CPI. The price index for GDP rises 2.0 percent in 1998, 2.1 percent in 1999, and 2.2 percent in the following years. The gap between the two measures of inflation, which has been larger in the past, narrows due to recent and expected methodological improvements in both indexes. Without these improvements, measured inflation would rise slightly more.

Interest rates: Interest rates, already lower than a year ago, remain below levels of recent years as the budget approaches balance. The yield on 10-year Treasury notes reaches 5.7 percent by 2001; on a discount basis, the 91-day Treasury bill rate drops to 4.7 percent.

The Administration does not try to project the business cycle beyond the next year or so. The expansion will surely end at some point, though no signs of a downturn have emerged. But even allowing for future recessions, projected economic growth averages 2.4 percent from 2001–2007, and projected unemployment averages about 5.4 percent. In some years, growth will be faster and unemployment lower, while in others, growth and employment will fall short of these projections. But, because the Administration expects the growth and unemployment assumptions to hold on average over this period, they provide a sound, prudent basis for projecting the budget. Similarly, the Administration expects inflation and interest rates to average near the projections shown in Table III–1, although year-to-year fluctuations surely will occur.

Investing in Economic Statistics

Our democracy and economy demand that public and private leaders have unbiased, relevant, accurate, and timely information on which to base their decisions. But rapid changes in the economy and society, and funding levels that do not enable statistical agencies to keep pace with them, increasingly threaten the relevance and accuracy of America's key statistics.

Economic data, in particular, are not only key indicators for fiscal and monetary policy; they also underlie Federal, State, and local income projections, investment planning, and business decisions. In recent years, active public debate has focused on the measuring of GDP, CPI, and many other indicators that are widely used, explicitly and implicitly, in public and private decision-making. Small but essential investments to address these measurement issues will allow our statistical system to track the economy more accurately and, in the process, help both Government and the private sector better allocate their limited resources.

The budget proposes such carefully targeted investments, ranging from improvements in data (including statistics on service industries, construction, and State and local government), to the development of more accurate summary statistics from those data (such as GDP and the National and Personal Income estimates), to greater public access to Government data (including electronic distribution). These initiatives are documented in greater detail in Chapter 11 of *Analytical Perspectives,* "Strengthening Federal Statistics."

Table III–1. ECONOMIC ASSUMPTIONS[1]

	Actual 1996	Projections 1997	1998	1999	2000	2001	2002	2003
Gross Domestic Product (GDP):								
Levels, dollar amounts in billions:								
Current dollars	7,636	8,080	8,430	8,772	9,142	9,547	9,993	10,454
Real, chained (1992) dollars	6,928	7,187	7,357	7,503	7,652	7,820	8,008	8,199
Chained price index (1992 = 100), annual average	110.2	112.5	114.6	116.9	119.5	122.1	124.8	127.5
Percent change, fourth quarter over fourth quarter:								
Current dollars	5.6	5.5	4.0	4.1	4.3	4.6	4.6	4.6
Real, chained (1992) dollars	3.2	3.6	2.0	2.0	2.0	2.3	2.4	2.4
Chained price index (1992 = 100)	2.3	1.9	2.0	2.1	2.2	2.2	2.2	2.2
Percent change, year over year:								
Current dollars	5.1	5.8	4.3	4.1	4.2	4.4	4.7	4.6
Real, chained (1992) dollars	2.8	3.7	2.4	2.0	2.0	2.2	2.4	2.4
Chained price index (1992 = 100)	2.3	2.0	1.9	2.0	2.2	2.2	2.2	2.2
Incomes, billions of current dollars:								
Corporate profits before tax	677	729	754	768	790	805	830	851
Wages and salaries	3,633	3,868	4,057	4,237	4,424	4,623	4,840	5,068
Other taxable income[2]	1,693	1,786	1,859	1,915	1,975	2,046	2,128	2,213
Consumer Price Index (all urban):[3]								
Level (1982–84 = 100), annual average	157.0	160.7	164.1	167.7	171.5	175.5	179.5	183.6
Percent change, fourth quarter over fourth quarter	3.2	2.0	2.2	2.2	2.3	2.3	2.3	2.3
Percent change, year over year	2.9	2.4	2.1	2.2	2.3	2.3	2.3	2.3
Unemployment rate, civilian, percent:								
Fourth quarter level	5.3	4.8	5.0	5.2	5.4	5.4	5.4	5.4
Annual average	5.4	5.0	4.9	5.1	5.3	5.4	5.4	5.4
Federal pay raises, January, percent:								
Military[4]	2.6	3.0	2.8	3.1	3.0	3.0	3.0	3.0
Civilian[5]	2.4	3.0	2.8	3.1	3.0	3.0	3.0	3.0
Interest rates, percent:								
91-day Treasury bills[6]	5.0	5.0	5.0	4.9	4.8	4.7	4.7	4.7
10-year Treasury notes	6.4	6.4	5.9	5.8	5.8	5.7	5.7	5.7

[1] Based on information available as of early December 1997.
[2] Rent, interest, dividend and proprietor's components of personal income.
[3] Seasonally adjusted CPI for all urban consumers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic adjustments to individual income tax brackets. Projections reflect scheduled changes in methodology.
[4] Beginning with the 1999 increase, percentages apply to basic pay only; adjustments for housing and subsistence allowances will be determined by the Secretary of Defense.
[5] Overall average increase, including locality pay adjustments.
[6] Average rate (bank discount basis) on new issues within period.

The Near-Term Budget Outlook, 1998–2003

The Administration projects that the budget will reach balance in 1999—ending an era of continuous deficits that lasted 30 years (see Chart III–7). By definition, projections are imprecise; the further into the future, the more imprecise. But, the Administration is committed to close the structural budget deficit and keep the budget in balance—as long as the economy maintains normal levels of unemployment.

The Outlook has Improved Since the Balanced Budget Act: Last summer, OMB and CBO both projected that the BBA would not produce a balanced budget until 2002. Since then, the budget outlook has improved. Economic growth has continued to exceed expectations, and inflation has remained low. The resulting changes in the Administration's economic and technical projections have reduced the projected deficits and moved the expected year of balance ahead to 1999 (see Chart III–8).

Chart III-7. BUDGET SURPLUS(+)/DEFICIT(-)

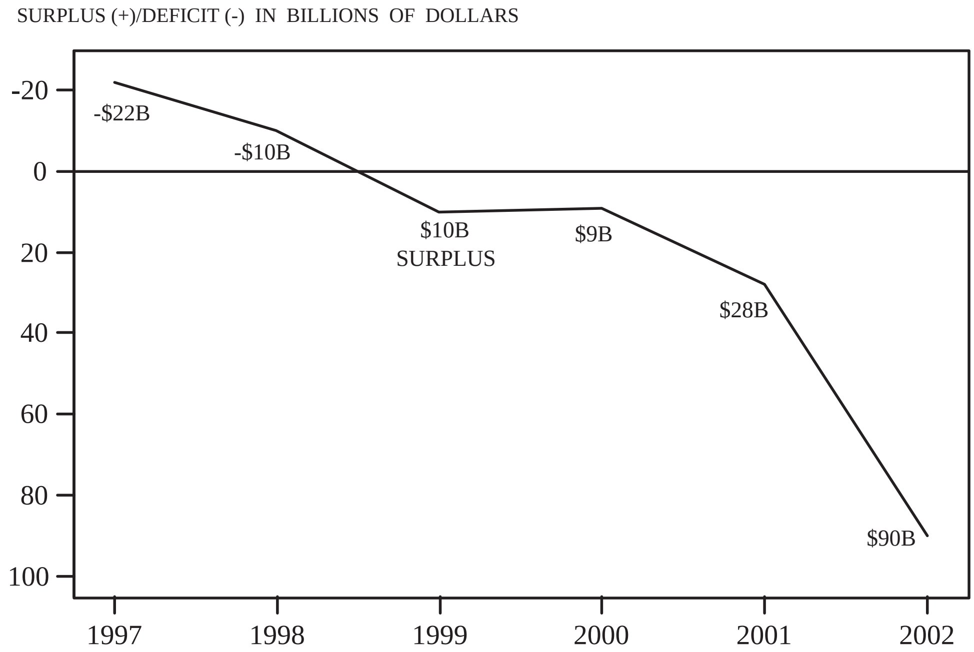


Chart III-8. CHANGES IN THE ESTIMATES OF THE BUDGET DEFICIT