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THE ECONOMIC AND DEFICIT IMPLICATIONS OF PRESIDENT CLINTON'S FY 1998 BUDGET

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INTRODUCTION

At the heart of every federal budget plan must be the promise of a stronger economy—more jobs, better wages, and greater economic security. The task facing Washington is to design a budget plan that eliminates the deficit while spurring a more vibrant economy for all Americans. Thus, changes in tax and spending policy should result in strengthening the economy while reducing the deficit.

To determine whether President Clinton's fiscal year 1998 budget, released on February 6, 1997, meets these goals, The Heritage Foundation used one of the principal econometric models of the U.S. economy—the WEFA Group's Mark 11 U.S. Macroeconomic Model—to simulate the economic effects of the President's budget were it to be implemented fully.

According to Heritage analysis using the model, the President's budget plan would mean the following:

- **Deficit.** The President's budget plan does not lead to a balanced budget by the end of FY 2002 when measured against the CBO's forecasts of future deficits. The President's budget plan would result in a deficit of $117 billion in 2002, $18 billion worse than that forecast by the CBO under current law.
- **Economic growth.** The President's plan results in an average, five-year rate of growth of 2.09 percent, slightly below the 2.11 percent average annual growth rate predicted by the Congressional Budget Office (CBO) under current law without policy changes.
- **Jobs.** The President's plan results in employment growth below that predicted by the WEFA model under CBO current law economic forecasts. The WEFA model predicts that the economy would produce 7.43 million new jobs between now and the end of FY 2002 under CBO current law economic forecasts. The President's plan results in only 7.35 million new jobs.

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Table 1

Clinton Budget Simulation Compared to No Change in Budget or Tax Policy: 1998-2002

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Real GDP (annual growth rate)					
Current Law	1.91%	2.24%	2.08%	2.10%	2.10%
President Clinton's Plan	2.07%	2.20%	2.05%	2.07%	2.00%
Difference	**0.16%**	**-0.04%**	**-0.03%**	**-0.03%**	**-0.11%**
Total Employment (millions of workers)					
Current Law	123.62	125.08	126.58	128.15	129.51
President Clinton's Plan	123.86	125.29	126.71	128.27	129.46
Difference	**0.24**	**0.21**	**0.13**	**0.13**	**-0.05**
Unemployment Rate					
Current Law	5.64%	5.83%	5.91%	6.02%	6.00%
President Clinton's Plan	5.47%	5.68%	5.82%	5.93%	6.03%
Difference	**-0.17%**	**-0.15%**	**-0.09%**	**-0.09%**	**0.03%**
% Rate of Consumer Inflation (as measured by the CPI-U)					
Current Law	2.91%	3.03%	2.97%	3.01%	3.03%
President Clinton's Plan	2.95%	3.16%	3.11%	3.14%	3.17%
Difference	**0.05%**	**0.14%**	**0.13%**	**0.13%**	**0.13%**
Federal Funds Rate (%)					
Current Law	5.03	4.87	4.83	4.74	4.73
President Clinton's Plan	5.10	5.11	5.25	5.30	5.39
Difference	**0.07**	**0.23**	**0.42**	**0.56**	**0.65**
Real Personal Disposable Income (annual growth rate)					
Current Law	2.01%	2.53%	2.15%	2.41%	2.59%
President Clinton's Plan	2.60%	2.19%	2.03%	2.40%	2.46%
Difference	**0.59%**	**-0.34%**	**-0.12%**	**-0.01%**	**-0.13%**
Federal Deficit ($Billion)					
Current Law	$124.17	$128.95	$123.76	$98.84	$99.18
President Clinton's Plan	$158.55	$156.63	$153.26	$130.79	$117.00
Difference	**$34.38**	**$27.67**	**$29.50**	**$31.95**	**$17.82**

Sources: Clinton Budget: Heritage estimates using the WEFA Mark 11 model; current law: CBO capped baseline.

THE BASELINE PROJECTION

When analyzing any budget proposal, there needs to be a "benchmark" against which proposed changes in spending and taxes can be gauged, for the simple reason that policymakers have to make assumptions about how the future economy will perform under current law and what the deficit will be before they can talk about the savings or income changes that will result from their plan. In his 1993 State of the Union address, President Clinton challenged Congress to stop the endless disputes over balancing the federal books that result when the White House uses one set of economic assumptions and Congress uses another. He promised Congress that his Administration would adopt the economic and deficit forecasts of the non-partisan CBO and use those numbers as the common "benchmark."

This gauge of future deficits and economic performance is known as the CBO baseline. It estimates what federal spending and revenues would be over the next five years under current law, that is, if no changes were made to federal spending or revenue policies.[1] In addition, the CBO baseline includes estimates of the major economic indicators, such as gross domestic product (GDP)[2] and inflation as measured by the Consumer Price Index (CPI).[3]

Heritage incorporated the CBO baseline into the WEFA Group's Mark 11 U.S. Macroeconomic Model to obtain a baseline projection of detailed activity in the U.S. economy given current law.[4] Heritage economists then used the CBO baseline and the WEFA Mark 11 Model to estimate the fiscal and economic effects of the President's budget and tax plan. Using the CBO baseline and the WEFA Mark 11 Model allows an analysis of the proposals outlined in President Clinton's budget to see what the model predicts would happen to key economic indicators, including federal spending and revenue collection, compared with the baseline. Such an arrangement facilitates an "apples-to-apples" comparison between what the world may look like with and without implementation of the President's budget.

HOW THE BUDGET SIMULATION WAS CONDUCTED

To conduct the simulation of the President's budget plan, Heritage economists first adjusted only those elements of the WEFA model that deal with federal spending and federal tax policy. Then modest but appropriate changes were made to the cost of capital that reflect how the President's tax policy changes are likely to affect the economy. It is important to note that Heritage economists made no assumption about how the proposed tax policy changes would affect employment and the labor force participation rates. All other economic and demographic settings were left unchanged. For a detailed explanation of the policy assumptions used, see the Technical Notes at the end of this report.

With respect to changes in spending policy, Heritage economists introduced the President's proposed discretionary and mandatory changes in full. The President's budget calls for increased non-defense, discretionary spending throughout the forecast period (FY 1998–FY 2002). The President's proposed increase in Medicare Part B premiums was entered into the model through higher federal receipts for medical insurance. The reductions in Medicare spending proposed by the President were reflected in lower federal spending for Medicare Hospital Insurance Trust Fund programs. Finally, the President's other mandatory spending proposals were entered into the model.

With respect to changes in tax policy, Heritage economists introduced the President's proposed changes in personal and corporate income taxes into the Heritage Individual Income Tax Model and the Heritage Business Tax Model. These models calculate the effects of changes in tax policy on the tax liabilities of individual taxpayers at every income level and businesses in every Standard Industrial Classification.

On the individual income tax side, Heritage economists estimated the changes in the average effective tax rate that would stem principally from three proposed tax policy changes: a tax credit for families with children below age 13, more liberal rules for individual retirement accounts, and tax incentives for education and training. These tax reductions produce a drop in the average effective individual tax rate of about 0.4 points after full implementation, which yields approximately $98 billion in tax savings over five years.

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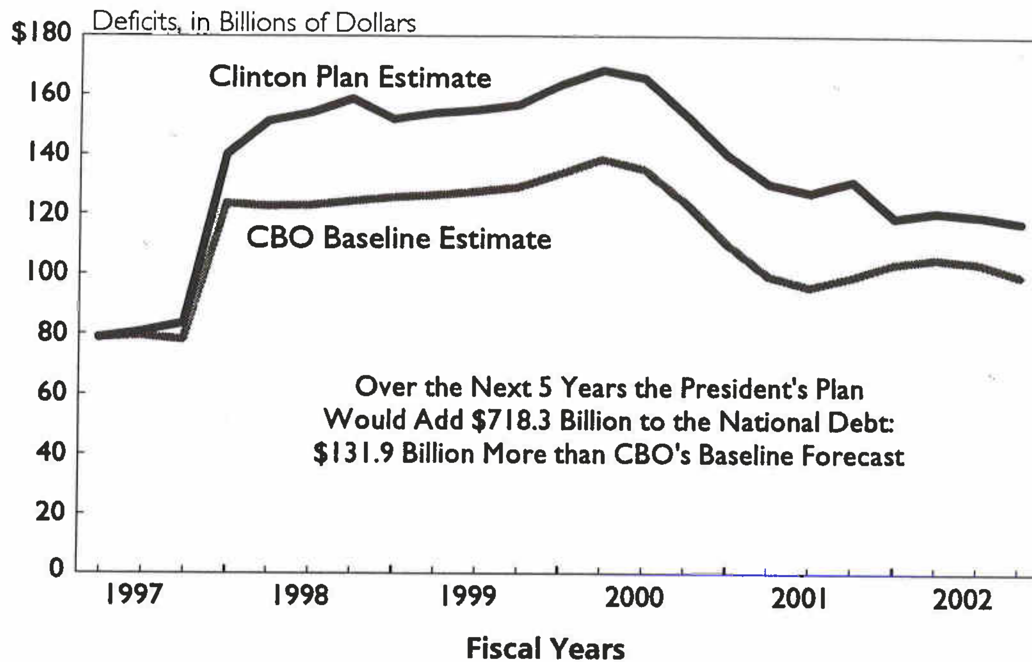
1 Specifically, this analysis uses the CBO capped baseline that assumes that discretionary spending will remain at its FY 1998 level through FY 2002.

2 Gross domestic product is the value of all final sales produced in the United States using land and equipment owned by U.S. residents.

3 For a full presentation of the CBO baseline see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998–2007* (Washington, D.C.: GPO, January 1997).

4 The WEFA Group's Mark 11 U.S. Macroeconomic Model was developed in the late 1960s by Nobel Prize–winning economist Lawrence Klein and several of his colleagues at the Wharton Business School of the University of Pennsylvania. It is widely used by Fortune 500 companies and by prominent federal agencies and economic forecasting departments.



On the business side, the President proposes myriad small tax changes, principally by expiring provisions of current tax law, mostly credits, deductions, and exemptions. The net effect of these policy moves is an increase in taxes paid by small and large businesses. Heritage economists introduced these higher business tax collections to the model by adjusting the effective tax rate for corporations.

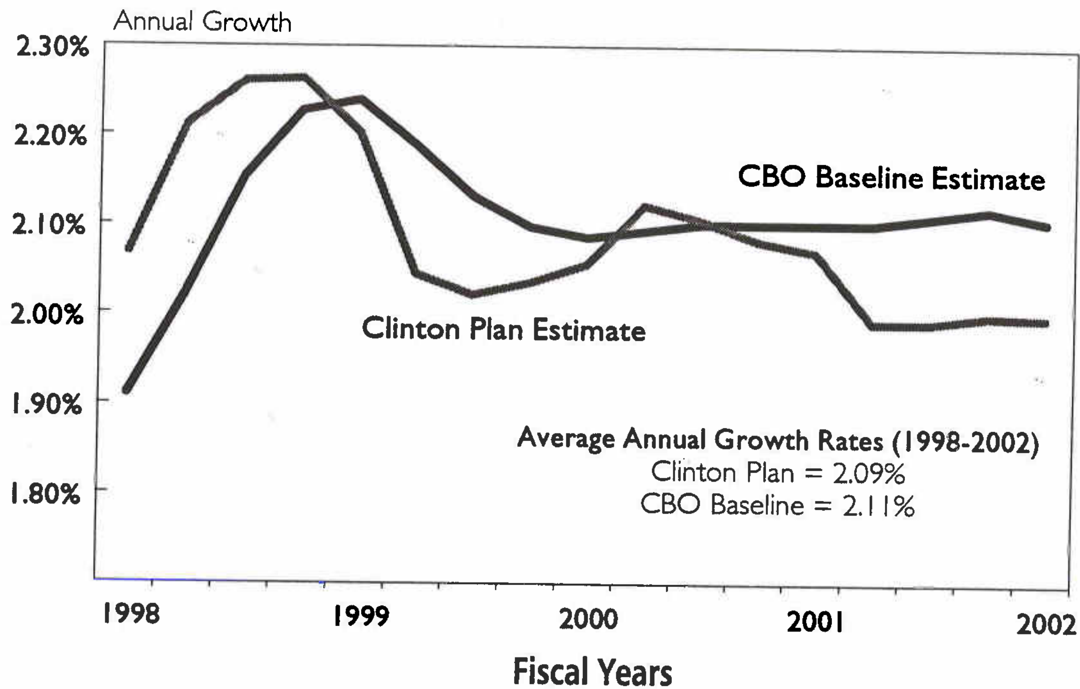
THE RESULTS

There are several principal findings from this analysis summarized in Table 1. Specifically,

- **The President's plan would fail to reach balance by FY 2002.** There are two reasons for this failure. First, the Administration fails to make spending cuts early in the budget period that would jump start the process of balancing the budget by the end of FY 2002. In fact, the President actually increases spending during the first three years of his five-year plan. The result is higher federal deficits that require higher net interest payments to service the growing federal debt. By the time President Clinton proposes to start reducing spending in real terms, the federal deficit turns out to be too large to overcome by the end of fiscal 2002.

  Second, the Administration's budget plan fails to make those kinds of tax cuts that facilitate economic growth that would generate new revenues to offset the early spending increases. Although some families would have $300 to $500 more to spend on their children and perhaps could afford more post-secondary education, for example, the budget plan does nothing to reduce overall tax rates or to eliminate the multiple taxation of income.

  The result is that the President's plan would result in a budget deficit of $117 billion in the third quarter of FY 2002. Moreover, the Administration's plan would add $718.3 billion



to the national debt over the next five years, $131.9 billion more than the CBO predicts under current law (see Chart 1).

- **The President's plan would slow the increase in economic growth.** The President's budget plan spends more money in the first three years than the CBO projects, given current law and spending levels. This extra spending gives a small but significant fiscal stimulus to the economy, which, in turn, results in slightly higher inflation and interest rates. The average inflation rate under the President's plan is 3.12 percent, while the CBO forecasts 2.99 percent. This higher inflation rate lifts key interest rates above their currently forecasted levels: the ten-year T-Bill rate rises 30 basis points, from 6.2 percent to 6.5 percent, and the key federal funds rate (the interest rate banks charge one another for inter-bank loans) rises from an average of 4.8 percent to 5.2 percent.

  Increased inflation and interest rates, combined with the higher taxes and user fees President Clinton's budget would impose on businesses, cause the user cost of capital to increase. Specifically, changes in interest rates make it more expensive for businesses to finance the purchase of productive assets, and tax increases reduce the earnings derived from the capital assets. Both these additional costs deter businesses from investing in capital assets and hiring more workers to use those assets.

  The end result of these key changes is slower economic growth than otherwise would occur.[5] The Heritage analysis using the WEFA model predicts that the economy would grow

5 In fact, the most recent Economic Report of the President, transmitted to the Congress in February 1997, states on page 30, "The first pillar of economic growth is increases in physical capital, which enable workers to produce