Joint Economic Committee Republicans
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Whither the Budget Deficit -- and Economy?

Executive Summary

A review of the budget data shows that the 1993 tax increase was devoted to federal spending increases, and that the decline in the deficit since 1992 is accounted for by factors unrelated to the 1993 tax increase. The largest single reason the deficit has declined in recent years is a continuation of the business cycle upswing underway since 1991. Special accounting factors and a reduction in discretionary defense spending explain the balance of the deficit decline since 1992.

Introduction

In recent months a variety of officials in the Clinton Administration have asserted that its policies have been responsible for the reduction in the budget deficit and continued economic expansion in recent years. While such claims from an incumbent Administration are to be expected under current circumstances, a review of the facts is needed to determine whether such assertions are credible or not.

The key to appraising such claims is the extent to which Clinton policies reduced the budget deficit, and the extent to which lower interest rates and higher economic growth followed. This paper will examine the Administration rationale for President Clinton's 1993 tax increase, and subsequent changes in interest rates and economic growth.

An analysis of the relationship between the deficit and the current economic expansion finds that Administration arguments reverse cause and effect. Deficit reduction did not cause an economic rebound; instead, a cyclical upswing already underway in 1992 was the largest single reason the deficit has declined in recent years. Furthermore, a nonpartisan appraisal would suggest that neither President Bush nor President Clinton deserve credit for the business cycle upswing that began in 1991.

Macroeconomic Effects of President Clinton's Tax Increase

A review of Administration statements on the 1993 tax increase proposal shows very clearly how its proponents expected it to affect the economy. The cornerstone of the argument was that the Clinton budget plan would "grow" the economy by lowering interest rates. Lower interest rates were the key link defining exactly how Clinton policy would boost the economy. **However, soon after enactment of the Clinton program in August of 1993, the Administration revised its economic growth assumptions *downward* for 1993 and 1994, and shortly thereafter long term interest rates began *rising*, not falling.** By July of 1994, the yield on a 30 year Treasury bond had risen to 7.6 percent, above the level in the first full month of the Clinton Administration.

In truth, interest rates had been trending downward from mid-1991 to the fall of 1993, reflecting a decline in inflation expectations. Inflation expectations are a key factor in interest rate movements, a fact acknowledged in Clinton Administration budget documents. The downward drift in interest rates ended shortly after the enactment of the Clinton tax increases in 1993, and interest rates started rising within several months.

By so closely identifying the Clinton budget with lower interest rates, the Administration cannot credibly claim that its policies boosted growth under higher interest rates. The key causal element in the Administration argument moved in the opposite direction predicted under its own policies. In addition, there is no school of economic thought that would support the notion that the 1993 tax increase would boost economic growth in the short run. Furthermore, there are additional reasons for scepticism about Administration efforts to link its policies to a continuation of economic growth.

A business cycle upswing was already well underway when the Clinton policy changes were under consideration. The continuation of an already existing expansion only indicates that any policy changes implemented were not damaging enough to end the business cycle, it cannot prove that policy changes had any positive effect on a previously existing expansion. Moreover, the pace of GDP growth slowed from the 3.7 percent annual growth rate set in 1992 (measured 4th quarter to 4th quarter) to 2.2 percent in 1993, 3.5 percent in 1994, and 1.3 percent in 1995. The rate of economic growth did not accelerate relative to its 1992 pace under the 1993 budget policies. Viewed in a longer term perspective, the rate of economic growth since 1992 is also unimpressive, consistent with an economy stuck in a slow long term growth path.

Clinton's Disappointment with 1993 Budget Legislation

President Clinton's recent expansive claims about the virtues of his economic policies would be more convincing if his real views on the topic were not a matter of public record. **As reported by Bob Woodward in *The Agenda*, President Clinton was bitterly disappointed with his budget plan even before it had cleared Congress. "Clinton did confide that he was deeply unhappy with his economic plan. 'I know this thing is a turkey,' the president said."**[1] **Woodward also wrote of Clinton advisor Paul Begala: "He realized, somewhat painfully, that he had become a salesman for a plan that neither he nor Clinton really believed in."**[2] President Clinton's recent glowing statements about his budget, while perhaps not surprising, are sharply at variance with his real views at the time of its enactment.

The Agenda also describes how the Clinton Administration's marketing of its budget plan was somewhat disingenuous. For example, a Begala memo outlining the Administration talking points was prepared to sell the public on the plan. "'This plan will create JOBS -- 8 million of them,' the memo said. In fact, the economy would create those jobs and the economic plan would have little direct impact . . . Begala was not fully comfortable with the simplistic, happy-talk memo."[3] It hardly needs to be added that somewhat higher than expected job growth would not be attributable to a plan that is a drag on economic growth.

Moreover, there was actually very little partisan disagreement about the direction of the economic effects of the Clinton budget plan in 1993. In 1993 both Democrats and Republicans

publicly expressed concerns about the drag the Clinton budget plan would impose on the economy. For example, Democrats on the Joint Economic Committee, including Senators Kennedy, Sarbanes, Dorgan, and Congressmen Obey, Stark, Mfume and Wyden, voiced their concerns in the 1993 *JEC Annual Report*. According to the *Democrat* views, the Clinton budget plan "will continue to exert downward pressure on economic activity through the next five years."[4] This view that the Clinton plan would exert "contractionary" pressure on the economic expansion was shared by Republicans as well.

In sum, neither an examination of the evidence nor economic theory supports the view that the Clinton budget plan was a sound policy to boost the economy in the subsequent 2 or 3 years. While criticism of the plan as harsh as that leveled by the President himself would be inappropriate here, it would also be gratuitous.

Finally, in its 1993 budget documents, the Clinton Administration, in condemning the alleged shortcomings of the 1980s, had made middle class income growth and reduction of inequality two major objectives of its budget policies. However, according to statistical research by the JEC confirmed by the Census Bureau, there has been no growth in median family income under Clinton policies. Furthermore, though less importantly, according to the measures used by the Clinton Administration, income inequality is currently more pronounced than during the Reagan years, or indeed any period since WWII. Judged by the same criteria used to condemn the 1980s, the Clinton Administration record on family income would have to be viewed as the most unfair in the last 4 decades.

Economic Cycles and Deficit Reduction

Official measures of the budget deficit have declined in 1993, 1994, and 1995. Despite the attempts of the Clinton Administration to credit its policies for the deficit declines, this appearance of progress after 1992 is greatly affected by the continued upswing in the business cycle, and special accounting factors, neither having anything to do with policy changes. The 1990-91 recession and the savings and loan bailout had bloated the projected 1992 budget deficit to astronomical levels, and the wide circulation of these projections had created an impression of imminent fiscal crisis. Any improvement from the exaggerated 1992 deficit projections would appear to be major progress.

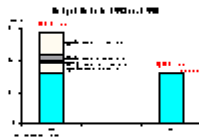
Just as the 1992 deficit had been pushed up by the recession, the deficit in following years had been pushed down by the economic upswing. Between 1992 and 1995, the deficit fell $71 billion due to the business cycle upswing. The continuation of the business cycle upswing is by far the largest single factor reducing the deficit in the first half of the 1990s. In other words, the economic expansion reduced the deficit, instead of the reduced deficit causing the economic upswing. The Administration argument reverses cause and effect to claim credit for continuation of the business cycle upswing already underway in 1991. The decline in the 1993, 1994, and 1995 deficits due to the business cycle expansion has nothing to do with the budget policies of the Clinton Administration.

As noted previously, the Clinton Administration had based its entire argument for the 1993 tax increase on the proposition that lower interest rates would increase economic growth.

However, soon after the Clinton tax increase was enacted, interest rates began to creep upward. Clearly, the Clinton Administration cannot claim its policies "grew the economy" when the key linchpin in its growth argument -- interest rates -- moved in the opposite direction predicted. Furthermore, even prominent Congressional supporters of the Administration tax increase acknowledged that it would slow, not increase, the pace of economic growth for five years.

Changes in the Budget Deficit, 1992-1995

A review of changes in the budget deficit between 1992 and 1995 shows that most of the decline has nothing to do with policy changes. According to the conventional deficit measure, the deficit declined from a level of $290 billion in 1992 to $164 billion in 1995. On the surface, this $126 billion decline appears significant. However, the great majority of the deficit decline reflects economic and accounting changes that have nothing to do with policy. A more accurate comparison of budget deficits would filter out the economic and accounting changes to make the deficit figures more consistent over time, as is done below. The figure below accounts for the sources of the deficit decline between 1992 and 1995.


Click here to see Figure.

Of the $126 billion decline in the deficit between 1992 and 1995, $71 billion is accounted for by a continuation of the business cycle, $21 billion by swings in deposit insurance outlays related to the S&L problem, and $8 billion by spectrum auctions.[5] These three factors account for $100 billion of the $126 billion decline in the deficit. When the effects of these three technical and economic factors are filtered out, the decline in the deficit is a much less impressive $26 billion. This decline in what we will call the adjusted deficit is accounted for by policy changes in one specific category of federal spending.

Defense Cuts Lower Budget Deficit

A review of the 1992-95 budget data shows a dramatic change in the levels of one spending category affected by policy changes -- discretionary defense spending. If this defense spending had remained at its $303 billion level of 1992, the deficit adjusted for major economic and accounting factors would have been virtually unchanged since 1992. Total increases in other federal spending categories would have just about equaled the amount of higher tax revenues between 1992 and 1995. However, discretionary defense spending had been cut $29 billion during this period. This cut in defense spending accounts for 115 percent of the $26 billion reduction in the adjusted deficit.

Outside of the defense category discussed, there has been virtually no net deficit reduction due to policy. The 1993 tax increase merely funded an increase in other federal spending. Moreover, deficits would be higher if President Clinton's proposed "stimulus," or "investment," spending increases had not been stopped by the Republican minority in Congress. To the extent

nondefense deficit reduction has been realized, it is due to stopping, not implementing, President Clinton's policies.

Baseline Budget Concepts and the Deficit

The analysis in this paper is based on cash accounting concepts from actual budget data, as opposed to changes in hypothetical budget levels postulated in baseline budgeting. The disuse of baseline budget concepts means that changes in spending levels from one year to another are the basis of analysis. For example, if a spending level has increased from 1992 to 1995, this is regarded as an increase, regardless of whether use of a baseline concept would designate it as a cut because the increase was below some hypothetical growth path. Baseline budget concepts have been questioned by many, including President Clinton. Recently when asked about the term "cuts" applied to slower than projected increases, President Clinton said, "When I came to Washington, I was amazed when I proposed budgets that that was the language that was used. The press used it. We all learned to use it from the press."[6]

In the case of revenues, an adherent of baseline budget concepts might argue that the real reason the deficit declined between 1992 and 1995 was because of the Clinton tax increase. However, a review of data related to the structural budget deficit shows that under the policies adopted, the increase of federal revenues between 1992 and 1995 of about $211 billion was used to finance an increase in domestic and entitlement spending of about the same amount. The reduction in discretionary defense spending is the primary reason the structural deficit declined.

Conclusion

A review of the changes in the structural deficit since 1992 reveals much less impressive deficit reduction than does the conventional measure. When the effects of the business cycle upswing and special technical factors are accounted for, the deficit reduction due to policy changes outside of defense are nil. All of this policy improvement in the deficit situation results from cutting discretionary defense outlays below their nominal 1992 levels. **Furthermore, all of the 1993 tax increase has been used to finance additional domestic and entitlement federal spending increases.** Since 1995, the more recent progress in fiscal 1996 is due to faster than expected revenue growth and slower outlay growth, especially the savings due to Congressional actions to restrain spending. This more stringent approach to domestic discretionary appropriations by the new Congress has resulted in further progress on reducing the structural deficit in 1996.

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Endnotes

1. Woodward, Bob. *The Agenda*. (New York: Simon and Shuster, 1994), p. 214.

2. *Ibid*. p. 261.

3. *Ibid*. p. 261.

4. *1993 Joint Economic Report*. (Washington, DC: Government Printing Office), p. 53.

5. Congressional Budget Office. *Economic and Budget Outlook*. (Washington, DC: Government Printing Office, 1996), p. 10.

6. Transcript of President Clinton's press conference, May 8, 1996.