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Public Sector Reports

Michigan **COMMENTARY**

The President's Economic Program: The Right Medicine?

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It is natural for man to indulge in the illusion of hope. We are apt to shut our eyes against a painful truth, and listen to the song of the siren till she transforms us into beasts . . . . For my part, whatever anguish of spirit it may cost, I am willing to know the whole truth; to know the worst, and to provide for it.

Patrick Henry

Last week President Clinton presented his economic plan to Congress and the American people. It is a bold plan designed to provide short-term economic stimulus, reduce the federal budget deficit, and encourage long-term investment in the economy. This paper discusses why the program is needed and the potential short- and long-term implications for the economy.

THE PROPOSAL

As shown in Exhibit 1, the president's five-year plan proposes spending cuts and increases and tax reductions and increases. If approved the plan will raise the deficit in the current year from a projected $319 billion to $332 billion and then gradually reduce it to $206 billion in FY 1997 from the projected level of $346 billion. Spending cuts over the five years total $354 billion ($128 billion in 1998), including $46 billion

EXHIBIT 1

President Clinton's Economic Plan
(billions of dollars)

	1993	1994	1995	1996	1997	1998	5-Yr.
Office of Management and Budget baseline	$319	$301	$296	$297	$346	$390	—
Spending cuts:							
Defense	0	-7	-12	-20	-37	-36	-112
Nondefense	1	-4	-10	-15	-20	-23	-73
Entitlements	0	-9	-18	-30	-41	-47	-144
Interest	0	0	-3	-7	-14	-22	-46
Subtotal	1	-20	-43	-73	-112	-128	-375
Stimulus outlays	8	6	2	1	0	0	9
Investment outlays	0	9	20	32	39	45	144
Revenue changes	3	-33	-34	-51	-68	-65	-251
Total changes	13	-39	-54	-92	-140	-148	-473
Resulting deficits	$332	$262	$242	$205	$206	$241	—

SOURCE: U.S. Office of Management and Budget, Washington D.C., February 1993.

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in reduced interest costs due to the lower deficits but excluding the tax on Social Security benefits, which the president counts as a spending cut but is really a tax increase. Spending increases total $153 billion ($45 billion in 1998), revenue increases total $350 billion ($90 billion in 1998), and tax incentives or decreases total $77 billion ($17 billion in 1998).

The largest revenue raisers (five-year estimates) are (1) $126 billion from adding a fourth income tax bracket at 36 percent for taxable income over $140,000 (joint return), a 10 percent surtax on taxable income over $250,000, changes in the alternate minimum tax, and extension of limitations on deductions and exemptions; (2) $49 billion from an energy tax (three-year phase-in beginning July 1, 1994); (3) $30 billion from increasing the corporate tax rate from 34 to 36 percent for taxable income above $10 million; (4) $29 billion from increasing the portion of Social Security benefits subject to taxation from 50 to 85 percent; and (5) $21 million from removing the wage base cap for the Medicare tax.

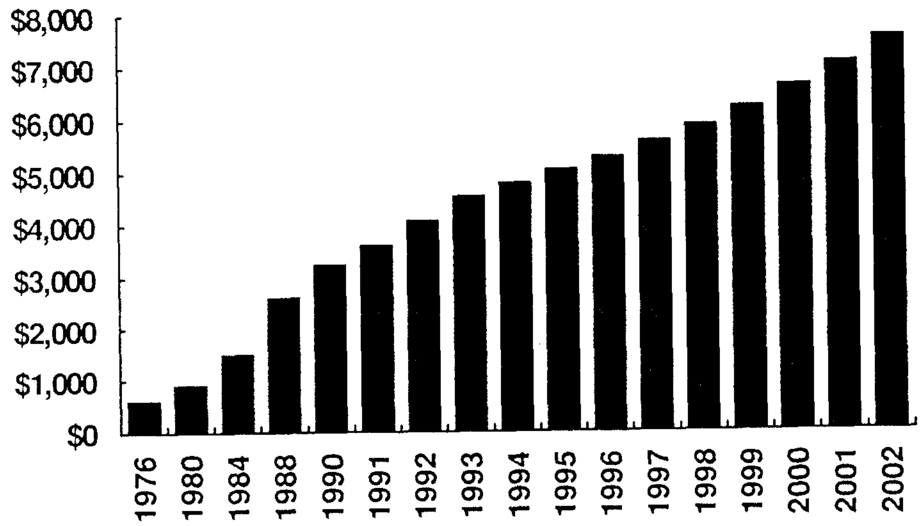
The largest tax cuts are $29 million for an investment tax credit and $27 million for an increase in the earned income tax credit for families with children.

THE PROBLEM

The nation faces two basic economic problems and they are closely related. First, the United States has experienced stagnant economic growth since 1989; real gross domestic product (GDP) increased at annual rate of one percent from 1988 to 1992 compared to 3.8 percent from 1983 to 1988. Second, the federal budget is running large deficits every year and the size of those deficits will begin to escalate after 1997. Total federal debt, the accumulation of the annual deficits, has increased from $900 billion in 1979 to over $4 trillion in 1992, $16,000 for every person in the nation, and will exceed $7 trillion by 2002 if nothing is done. (See Exhibit 2.) The interest on this debt is $200 billion, about 14 percent of total outlays, and is projected to reach $437 billion in 2003, almost 18 percent of total outlays.

EXHIBIT 2

Total National Debt, Selected Years Between 1976 and 2002
(billions of dollars)

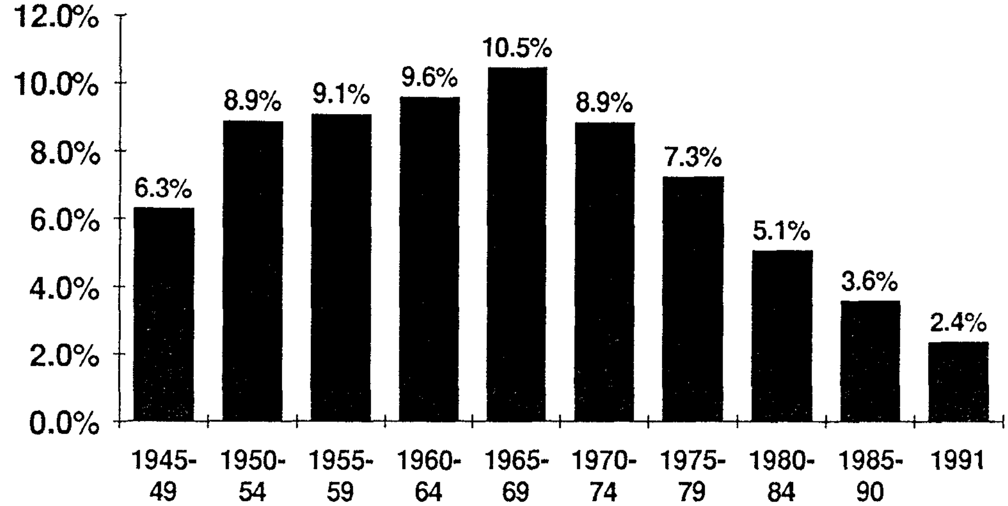


SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994–98*, Washington, D.C., January 1993.

There are several reasons why economic growth has been so weak in recent years. The major ones are the decline of saving and investment and the increase in real interest rates, both of which are directly related to the federal budget deficit. As shown in Exhibit 3, net national savings have declined steadily in the last 25–30 years, down from 10.5 percent of GNP in the 1965–69 period to 3.6 percent in the 1985–90 period.

EXHIBIT 3

U.S. Net National Savings as a Share of GNP, Five-year Averages



SOURCE: Council of Economic Advisors, *Economic Report of the President*, February 1992. Calculations by Public Sector Consultants.

When the government borrows it drains savings available for private investment. The Congressional Budget Office (CBO) has estimated that elimination of the deficit by 1998 could increase national savings by about 5 percent of GDP in 2003. The effect of reduced savings on investment is shown in Exhibit 4. As savings have declined so has investment. Part of the decline has been made up by foreign investment, which is why overall investment was able to remain above savings in the 1980s. The amount of foreign investment in the United States has fallen, however, due in part to lower U.S. interest rates and poor worldwide economic growth. This decline will make the federal deficit an even more serious problem.

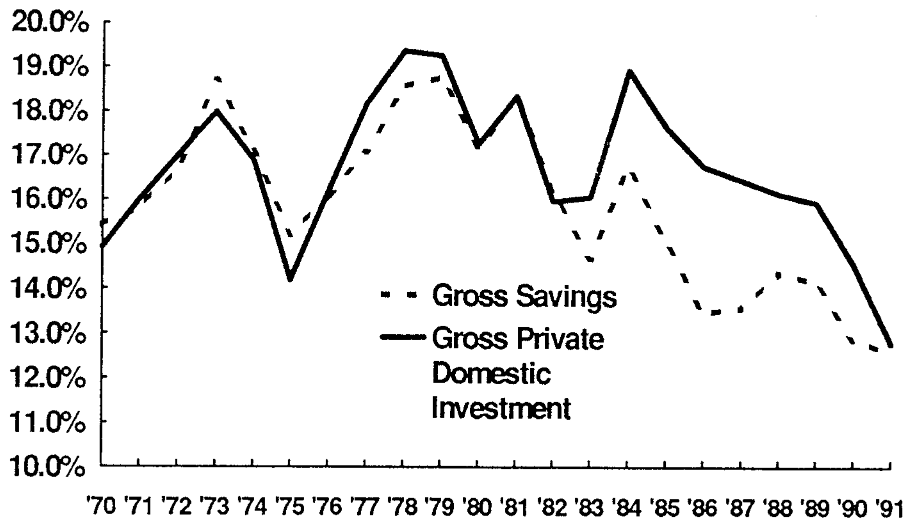
The deficit also stifles investment by driving up real interest rates, as government borrowing increases the demand for capital, pushing up the price of money (interest rate). Currently, real long-term interest rates are about 4.5 to 5 percent. Historically, real rates have been about 2 to 3 percent. With a balanced federal budget, interest rates could be as much as 2 percent lower, a powerful stimulus for investment.

Without sufficient investment, growth in productivity will lag, and without productivity growth our standard of living cannot improve. (See Exhibit 5.) In the 1960s productivity grew about 3 percent annually; in the 1980s growth was a little over one percent annually.

It appears that the economy is beginning to recover, but the recovery is unlikely to be sustained without deficit reduction. If we do not bring the deficit under control, the economy will be characterized by periods of slow economic growth interrupted by recessions.

EXHIBIT 4

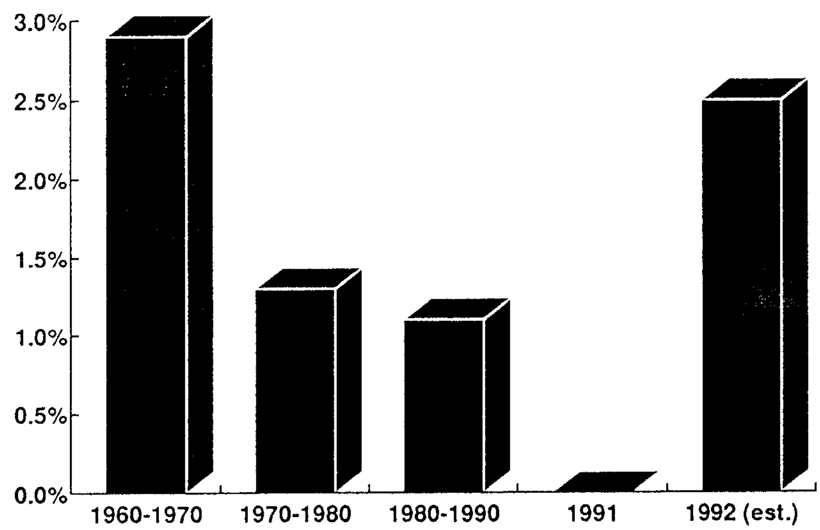
Gross Saving and Gross Private Domestic Investment as a Percent of GNP, 1970–91



SOURCE: Council of Economic Advisors, *Economic Report of the President*, February 1992. Calculations by Public Sector Consultants.

EXHIBIT 5

U.S. Productivity Growth, 1960–92



SOURCE: Council of Economic Advisors, *Economic Report of the President*, February 1992. Calculations by Public Sector Consultants.

A key question is whether the president's short-term economic stimulus program is really needed. Clearly, we cannot grow our way out of the deficit problem, even if the economy does recover. According to the CBO,

> more rapid economic growth is not going to slay the deficit dragon. Even if the economy were to expand one percent a year more rapidly than the CBO assumes—an unlikely outcome—the deficit would still total $230 billion in 1998.[1]

Economists such as Alan Greenspan and Martin Feldstein argue that the only short-term stimulus needed is deficit reduction, and I concur. The economic stimulus part of Clinton's package, however, is politically astute. The president promised to create jobs, and the sooner he does so the better. If the economy improves in the short run it will give the president more political capital and make it easier for him to enact his programs. It will also boost economic confidence.

To sum up, let's put this in a personal context. What the federal government is doing is the same as a family that earns $30,000 annually and spends $35,000. Each year the family borrows $5,000, and the cost of carrying the debt increases and becomes a larger share of income, unless that income rises at a very fast rate. Of course, unlike the government the family must pay back principal and interest. It will not take too many years before the debt exceeds family income and the debt payments become onerous.

SOME MISCONCEPTIONS

Several arguments are being made against the president's program. The first is that tax increases will be counterproductive and slow economic growth. The second is that the cuts in the budget are not deep enough. The third is that we passed a budget deficit package in 1990 that included tax increases and the deficit still increased. The fourth is that the nation is not in crisis and our economy is starting to recover on its own.

All these arguments are related, but let's examine each separately.

First, it is true that tax increases can slow economic growth, but so can budget reductions. My expectation is that the negative effect of higher taxes will be offset by improved consumer confidence and lower interest rates—long-term rates have fallen about 40 basis points in the last month and further declines are likely if the plan is approved. Bill Clinton's election has already sharply increased consumer confidence and enactment of this plan will improve it more. If a creditable deficit reduction plan is not adopted, I expect long-term rates to jump at least one percentage point, which will certainly slow the economic recovery. The American people are thirsting for a strong leader who will take positive action to move the country forward, even if it means higher taxes. This has been reflected in the early positive public response to the president's plan.

Second, I agree that more budget cuts are needed and hope that Congress increases the size of the cuts, but I won't hold my breath. Spending is part of the problem, but it is not all of the problem. From FY 1983 to FY 1992 federal outlays increased at an annual rate of 6.9 percent, while revenues increased at an annual rate of only 6.1 percent. Adjusted for inflation, outlays increased at an annual rate of only 0.9 percent, hardly runaway spending. Federal outlays were 24.4 percent of GDP in 1983 and 23.5 percent in 1992. Revenues were 18.1 percent of GDP in 1983, down from 20.2 percent in 1981 and 18.6 percent in 1992. Unfortunately, the Reagan tax cuts ran the deficit up to $208 billion, or 6.3 percent of GDP in 1983, and not enough was done to cut it while the economy was strong. The real problem is that spending accelerates in the future. The CBO is projecting annual spending increases of only 4.6 percent from 1992 to 1997, but the annual increase rises to 6.9 percent from 1997 to 2003.

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1 Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Washington, D.C., January 1993.

More important than fiscal realities, however, are political realities: Substantial spending cuts are needed to sell Clinton's program. The public believes that the federal budget includes large amounts of waste, and if the president and Congress do not deliver large spending cuts, people will turn against the program. Excluding defense (which was already slated for reductions), interest on debt, fees, and savings from changing debt maturities, the cuts are less than $170 billion. This may not be enough to satisfy the public.

We should not underestimate the difficulty of reducing the budget, however. As shown in Exhibit 6, only 37 percent of the budget is discretionary, down from more than 60 percent in 1970. Discretionary spending excludes interest on the debt and entitlements, such as Social Security and Medicaid. It includes defense and the rest of federal government operations. In FY 1998 Social Security, Medicare, and interest on the debt will make up about 50 percent of the budget. If these items cannot be reduced, that puts the entire burden on the remaining half of the budget, 45 percent of which includes such hard to cut programs as Medicaid, food stamps, civilian and military retirement, veterans' benefits, and unemployment compensation.

EXHIBIT 6

Distribution of Federal Expenditures

	1970	1992	2002
Social Security	14.2%	19.5%	19.6%
Medicare	3.3	8.9	15.2
Medicaid	1.3	4.7	9.1
Retirement	3.2	4.0	3.8
Net interest	6.9	13.7	16.5
Other entitlements	10.2	12.1	8.5
Discretionary	60.9	37.1	27.3

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994–98*, Washington D.C., January 1993.

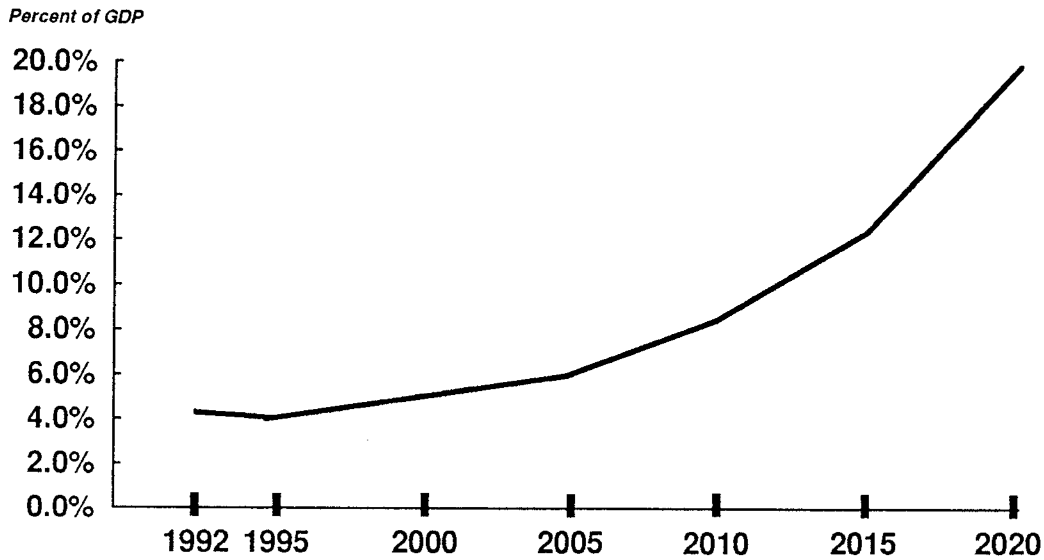
Third, the disingenuous argument that this plan won't work because the 1990 budget agreement didn't work is wrong. President Bush disowned the 1990 agreement, but it was one of his best achievements. The CBO estimates that without that agreement the deficits would be higher by $89 billion in FY 1993, $131 billion in FY 1994, and $160 billion in FY 1995. Deficits of that size would be incredibly difficult to deal with. Some argue that the 1990 agreement slowed economic growth, which may be true, although the economy was slowing before the agreement. My estimate is that even if all the 1990–92 slowdown is attributed to the agreement, the FY 1995 deficit would still be $130 billion higher (assuming a $30 billion reduction in revenues) if nothing had been done.

Fourth, it may be true that this country is not facing an immediate crisis, but if we wait until a crisis is full blown it may be to late to deal with the problem. The deficit is expected to rise from $346 billion in FY 1997 to $663 billion in 2003, or from 4.6 percent to 6.8 percent of GDP, and based on the experience with earlier estimates, these are probably optimistic figures. Beyond 2003 the deficit continues to rise. According to the U.S. General Accounting Office, the deficit could reach 20 percent of GDP by 2020, and interest payments will account for 31 percent of all expenditures (see exhibits 7 and 8). Much of this huge increase is related to the aging of the population and the retirement of the more than 80 million baby boomers, which will sharply increase health and retirement costs (see Exhibit 9).

A related problem is that we are spending the surplus in the Social Security Trust Fund (estimated at $88 billion in FY 1998) for current consumption. Excluding this surplus the deficit would be a projected $445 billion rather than $357 billion in FY 1998. We are leaving this bill to our children. It is estimated that to pay for Social Security in 2020, the combined payroll tax, which is now 15 percent, will have to be 29 to 37

EXHIBIT 7

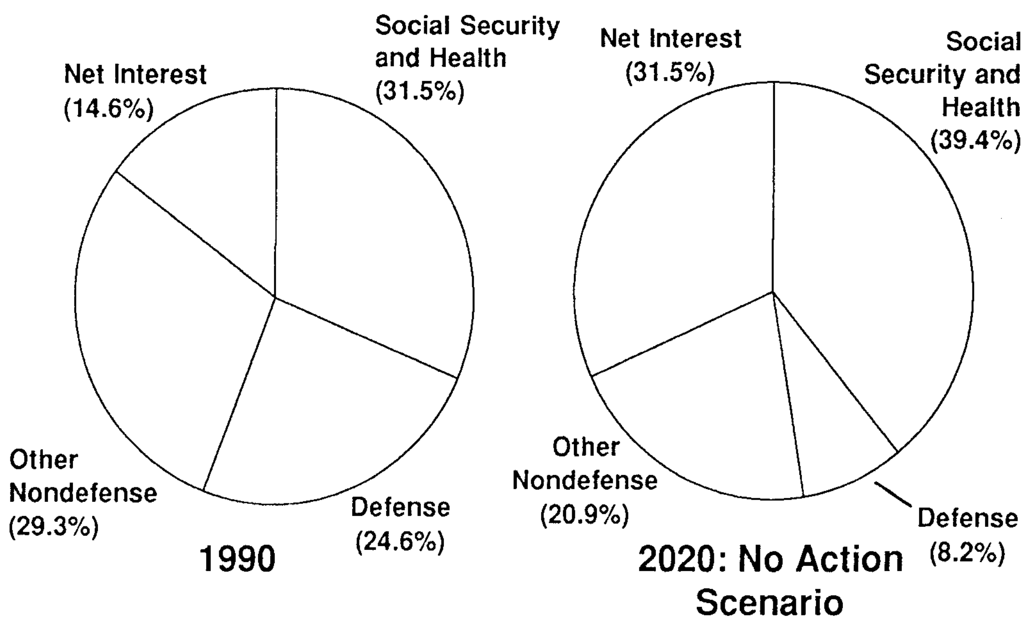
No Action Scenario Budget Deficits, 1992–2020



SOURCE: United States General Accounting Office, *Prompt Action Necessary to Avert Long-Term Damage to the Economy*, Washington, D.C., June 1992.

EXHIBIT 8

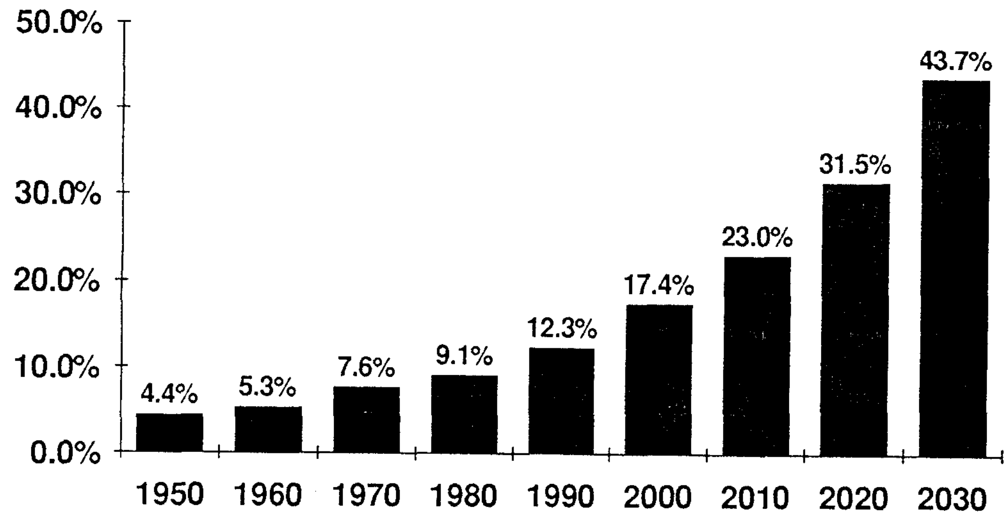
Share of Federal Expenditures



SOURCE: United States General Accounting Office, *Prompt Action Necessary to Avert Long-Term Damage to the Economy*, Washington, D.C., June 1992.

EXHIBIT 9

U.S. Health Care Spending as a Share of GDP, 1950–2030



SOURCE: Daniel R. Waldo, et al., "Health Spending Through 2003: Three Scenarios," *Health Affairs*, Winter 1992.

percent. This will create intergenerational warfare in which seniors fight cuts in their benefits and younger workers rebel against confiscatory taxes. If this is not a crisis, I don't know what is.

Overall, I believe Clinton's program is fair. It demands sacrifice from almost everyone, with more of the burden placed on higher income people. I do not believe in soaking the rich, but the data on income distribution provide some rationale for asking the upper income groups to contribute. In the 1980s in Michigan the real incomes of the richest 20 percent of families increased 8.8 percent, while the real incomes of the poorest 20 percent fell 13.7 percent.[2] The national figures are similar but less extreme.

The energy tax is controversial, but it will not place an undue burden on anyone and will conserve energy and help the environment. Any negative effect on the Michigan economy will be more than made up by the economic benefits resulting from deficit reduction. Nonetheless, I would have preferred a value-added or expenditure tax (a tax on income less savings), both of which would encourage saving and discourage consumption and can raise large amount of money at low rates, thereby reducing the effect on any one sector of the economy.

If anything the president's plan does not go far enough. As explained above, rising deficits in the future will require another deficit reduction program a few years down the road, unless the president's health care reform program sharply slows the growth in costs and the economy grows faster than expected. The plan is based on the assumption that real GDP will increase 2.5 percent annually from 1992 to 1998, a conservative estimate. If real growth is only 3 percent, revenues will be about $30 billion higher in 1998.

2 Center on Budget and Policy Priorities, *Where Have All the Dollars Gone?*, Washington, D.C., August 1992.

CONCLUSION

The bottom line is pay me a little now or pay me a whole lot more later. If Congress does not enact this program or a similar deficit reduction program, the American people may have to turn to a third party or a leader like Ross Perot to save the country from the special interests and the politicians. I don't think it will come to that, but we all have to stop being Republicans and Democrats and start being Americans. Our children deserve no less.

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