2. THREE YEARS OF PROGRESS

As President Clinton took office in January 1993, the economy was only then emerging from a long period of sluggish growth—beginning with the 1990–1991 recession and continuing through an extremely weak recovery, marked by rising unemployment.

The sluggishness exacerbated some serious long-term trends. Since the early 1970s, the incomes of most Americans have not grown as much as they once did—in fact, not much at all. As discussed in the previous chapter, only those atop the income ladder have enjoyed steady income growth. For others, the daily struggle to make ends meet has threatened to become a losing battle. For workers with only a high school education, times have been especially tough.

The President campaigned on a pledge to restore widely shared prosperity, and he shaped his economic policies to achieve this primary goal. The huge Federal budget deficit was a major obstacle. Others included sluggish business investment, slow job growth, and the overgrown Federal Government, about which the public had grown deeply cynical.

Three years later, our economy is stronger and the deficit is down even more than we had predicted. In dollar terms, the policies that we enacted with the last Congress have cut it almost in half, from $290 billion in 1992 to $164 billion in 1995. As a share of the economy, we have cut it by over half, to 2.3 percent (see Charts 2–1 and 2–2).

But as detailed in Chapter 1, we need further action to balance the budget once and for all.

The Administration also has begun to significantly change the way that the Federal Government works. Under the leadership of the Vice President's National Performance Review, we are working to create a Government that "works better and costs less."

Since January 1993, we have cut the number of Federal employees by over 200,000, to its lowest level in 30 years; the Federal share of the civilian workforce is at it lowest level since the 1930s. We are eliminating 16,000 pages of Federal regulations. We have reformed Federal procurement so that the Government now buys at the best price; no longer do we read news accounts of $600 hammers. (For more details on how we are making Government work, see Chapters 13 and 14.)

Meanwhile, the Administration has employed Government where it does the most good—investing in education and training, protecting the environment and public health, helping people get needed health care, strengthening families by helping America's neediest children, and rewarding work. On the world stage, the President has strengthened American leadership and advanced American strategic and economic interests and values.

Still, we have much more to do. Fully reversing the long-term trends that have weakened America will take time and enormous effort.

This chapter reviews what we have done to meet the economic and social challenges that the Administration inherited three years ago. It describes how the economy and society have responded to these initiatives, and the economic path that we envision for the future.

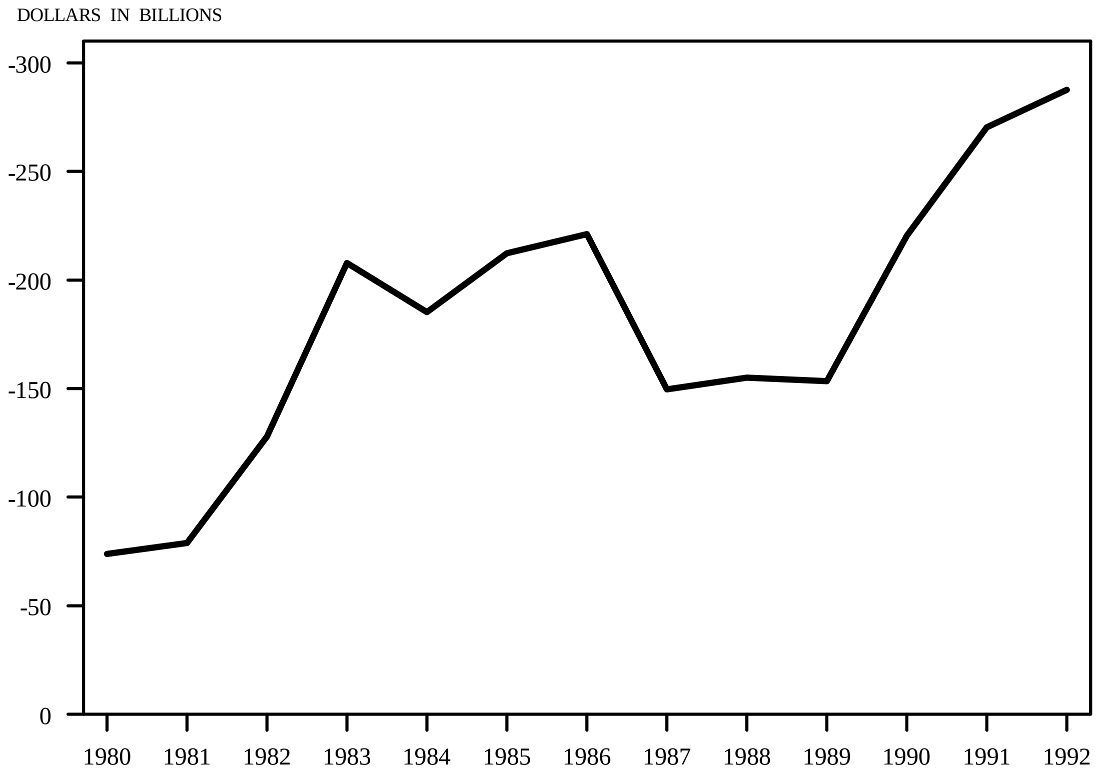
WHAT THE ADMINISTRATION INHERITED

Near-Term Economic Problems

The President inherited an economy that had nominally escaped from recession, but had not yet resumed solid and sustainable economic growth either for the short term or further down the road.

Unemployment: Unemployment rose sharply in late 1990 with the onset of recession. Though the recession technically ended in early 1991, growth was so weak for many months that unemployment continued to rise. In January 1993, unemployment was 7.1 per-

Chart 2-1. FEDERAL BUDGET DEFICITS



cent, about a quarter-point higher than when the 1990–91 recession ended.

Although the economy created some new jobs in the recovery of 1991–92, net job creation was weak. In the four years before January 1993, the economy created just 2.4 million net new jobs—about 51,000 a month. Over the same period, the labor force grew by 80,000 people each month. With the number of potential workers rising faster than the number of jobs, higher unemployment necessarily followed.

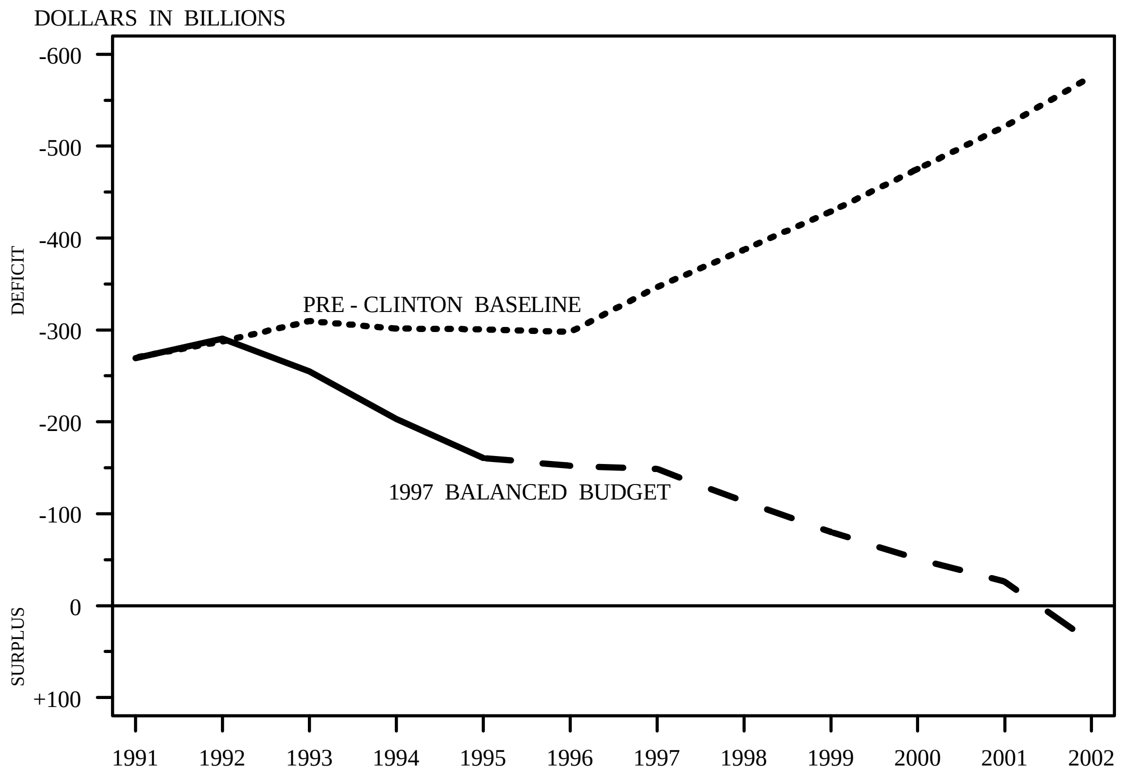
Slow Growth: Weakness in the labor market reflected weak economic activity in general. The economy was growing, but very slowly. From the start of 1991, through the first quarter of 1993, real Gross Domestic Product, or GDP, grew at well under half the rate of economic recoveries since 1960 that lasted at least that long.

The Credit Crunch: The U.S. financial system showed increasing strains in the 1980s. Individuals and corporations pushed their debt burdens higher and higher, and interest payments absorbed more and more income. While the amount of debt was rising, its quality was falling. Savings and loan institutions and banks made some extremely risky loans, many of which proved worthless.

As losses to the Government's deposit insurance programs mounted, the problems of deteriorating credit quality and failing financial institutions became clear. Bank and thrift regulators began to close the failed institutions and the surviving ones raised their credit standards sharply. Many businesses, especially in areas with heavy concentrations of bad loans, had trouble getting needed credit.

Meanwhile, individuals and businesses reduced their borrowing to improve their balance sheets and cut the burden of their interest payments. These steps led to slower consumer spending and less real estate investment. In cities across the country, new construction

Chart 2-2. THE DEFICIT RECORD UNDER PRESIDENT CLINTON



came to a halt as developers scrambled to find tenants for empty office buildings.

Long-Term Problems

The economy's cyclical problems were just part of what the new Administration faced. Underlying those problems were chronic conditions that had lasted over a decade. Among the most damaging were the Federal budget deficit, the fall in private saving, the slowdown in productivity growth, and the increase in income inequality.

The Budget Deficit: The Government has incurred a deficit every year since 1969, but the deficit exploded in size in the 1980s—largely due to the fiscal policies of 1981 and the economic conditions of that day.

The Administration and Congress cut income tax rates by 23 percent, reducing revenue by over four percent of GDP, and increased spending on defense. The tax cuts, higher defense spending, and second recession in two years combined to send the deficit soaring. By 1983, it had nearly tripled, to $208 billion, and since then has never fallen below $149 billion.

Higher and higher deficits brought more and more debt. From the start of the Republic to 1980, the Government had accumulated just under $1 trillion in debt. From 1980 to 1992, the debt rose to $4 trillion.

To be sure, a big deficit can help to stabilize the economy during a recession. But this deficit was harmful because it was "structural"; it would continue even if the economy performed well. Despite numerous attempts to cut the deficit over the next decade, it threatened to reach unsustainable levels as this Administration assumed office.

A structural deficit is important because it affects the Nation's pool of saving. Nations must set aside funds today to build the factories and machines that will generate income for tomorrow; what they set aside is their saving. It has two components: (1) private saving (by individuals and businesses); and (2) public saving (by Federal, State, and local governments).

If the Federal Government borrows from that pool to finance its deficit, then the borrowed saving is not available to make productive private investment. With its big deficits, the Federal Government in the 1980s massively drained our Nation's saving pool. Worse, as Federal deficits were rising, private saving was falling, making the Nation's saving problem worse.

Private Saving: Private saving averaged 13.3 percent of GDP in the 1960s, but dropped to 7.3 percent in the 1980s (see Chart 2–3). A fall in private saving affects investment and the trade balance in the same way as an increase in the budget deficit. Thus, the fall in private saving exacerbated the economic effects of the higher budget deficit.

In the 1980s, lower national saving pulled down investment. To some extent, the drop in investment was offset by more borrowing from abroad. But that, in turn, led to other problems—including a rising trade deficit. Increased foreign borrowing converted the United States from the world's largest creditor to its largest debtor nation. To service those debts, the Nation will have to increase its exports over its imports for the foreseeable future (see Chart 2–4).

Thus, because of the higher deficits and lower private saving, the 1980s economic expansion was financed by debt to an unprecedented degree (see Chart 2–5). Much of the extra borrowing was not backed by more assets; thus, the borrowing raised the burden of debt service without providing a corresponding increase in resources to service the debt. High real interest rates, caused by the higher borrowing, further aggravated the problem.

Chart 2-3. SAVING RATES

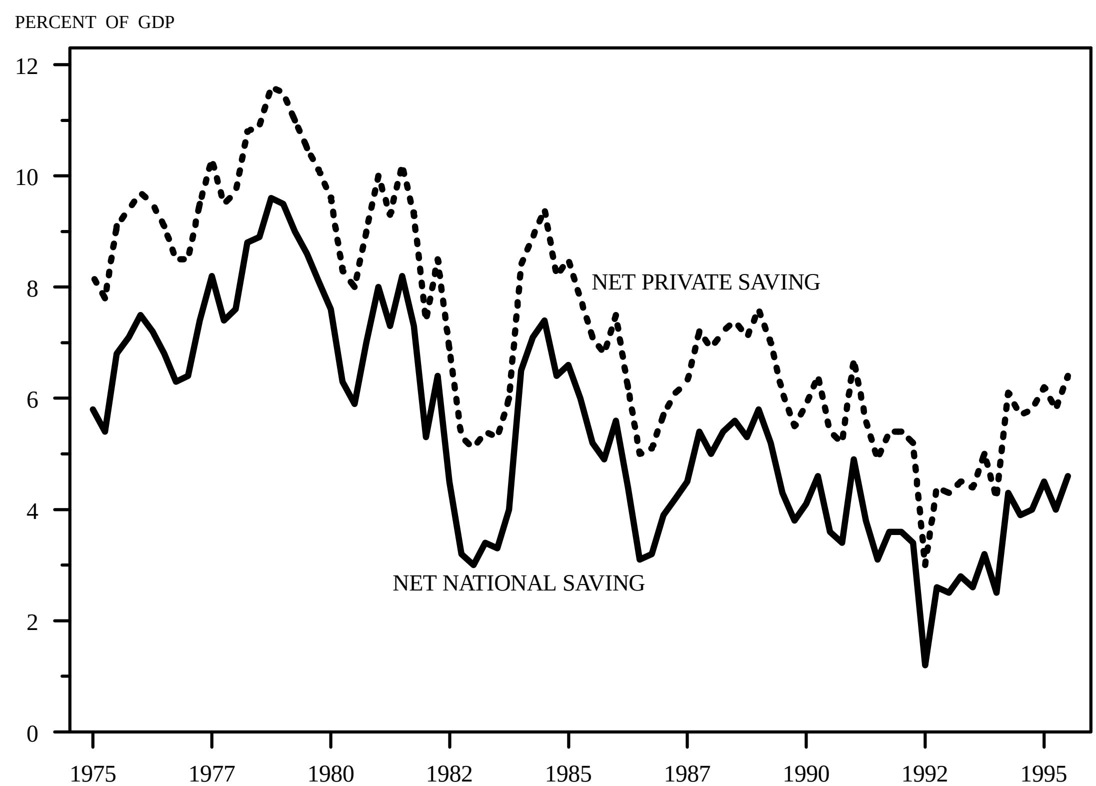


Chart 2-4. U.S. NET INTERNATIONAL INVESTMENT POSITION

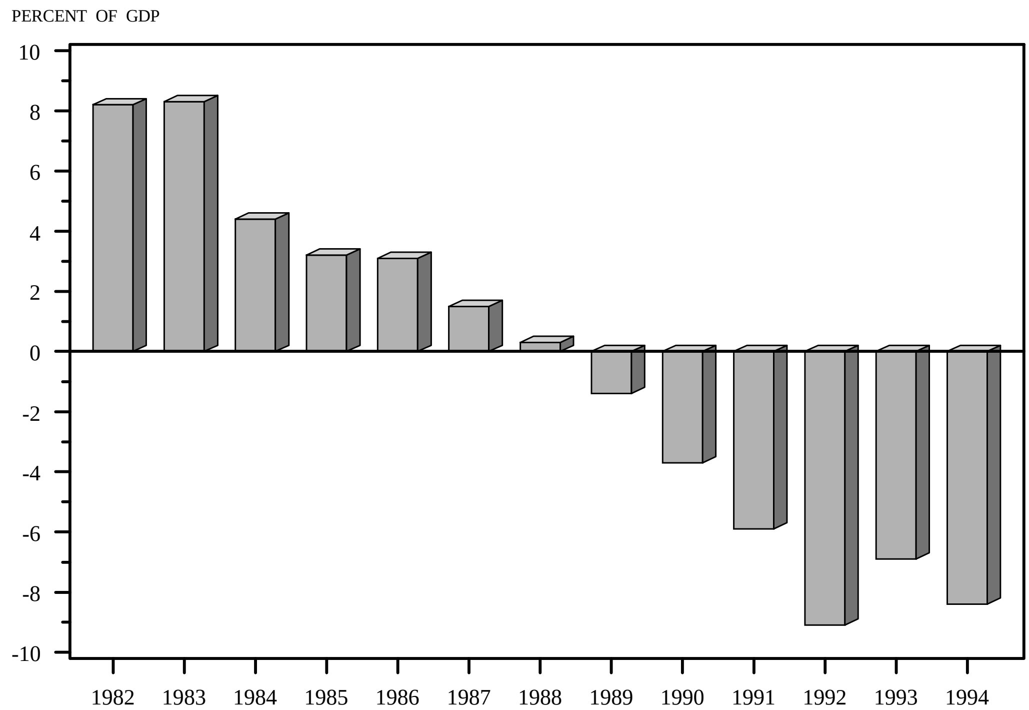


Chart 2-5. NONFINANCIAL DEBT

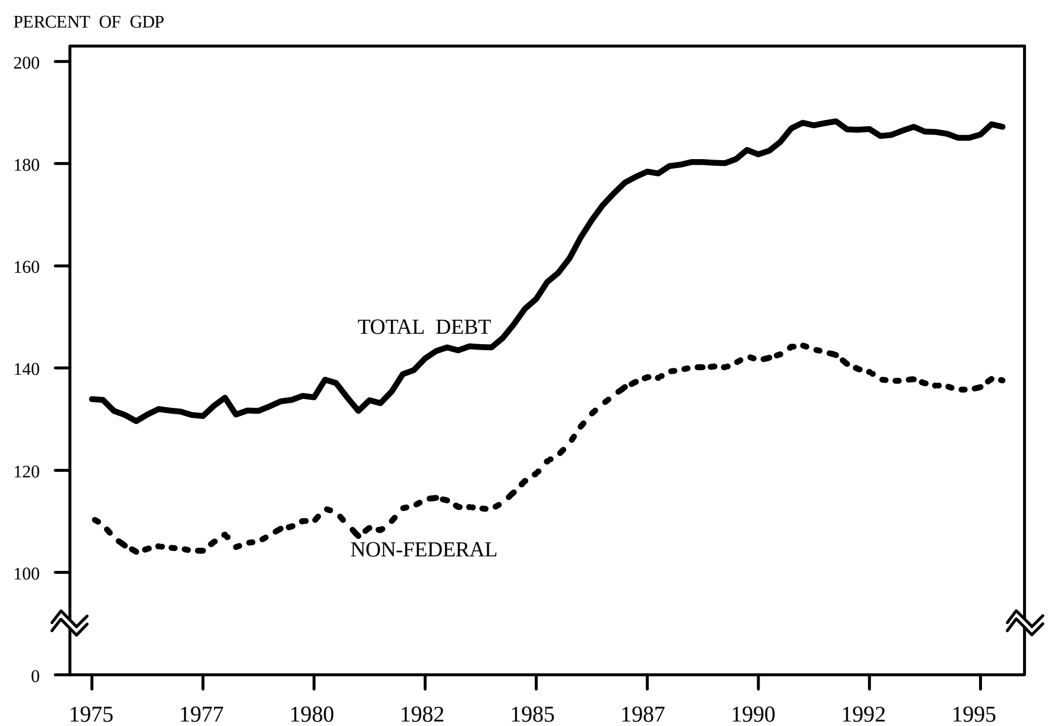


Chart 2-6. PRODUCTIVITY OUTPUT PER HOUR IN THE NONFARM BUSINESS SECTOR

(average annual growth rates in percent)

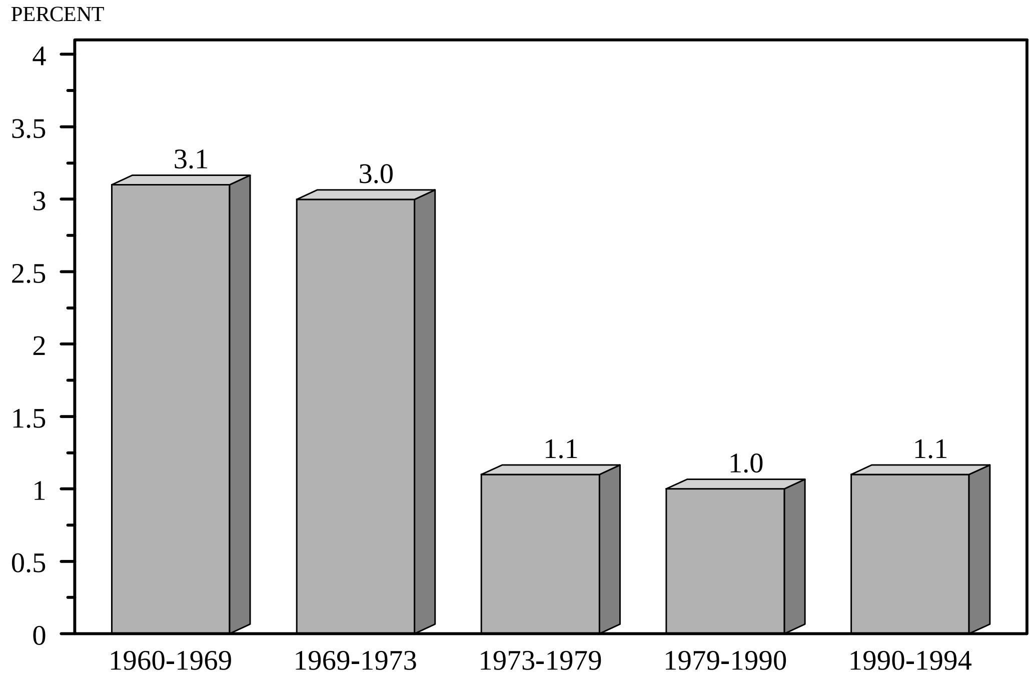
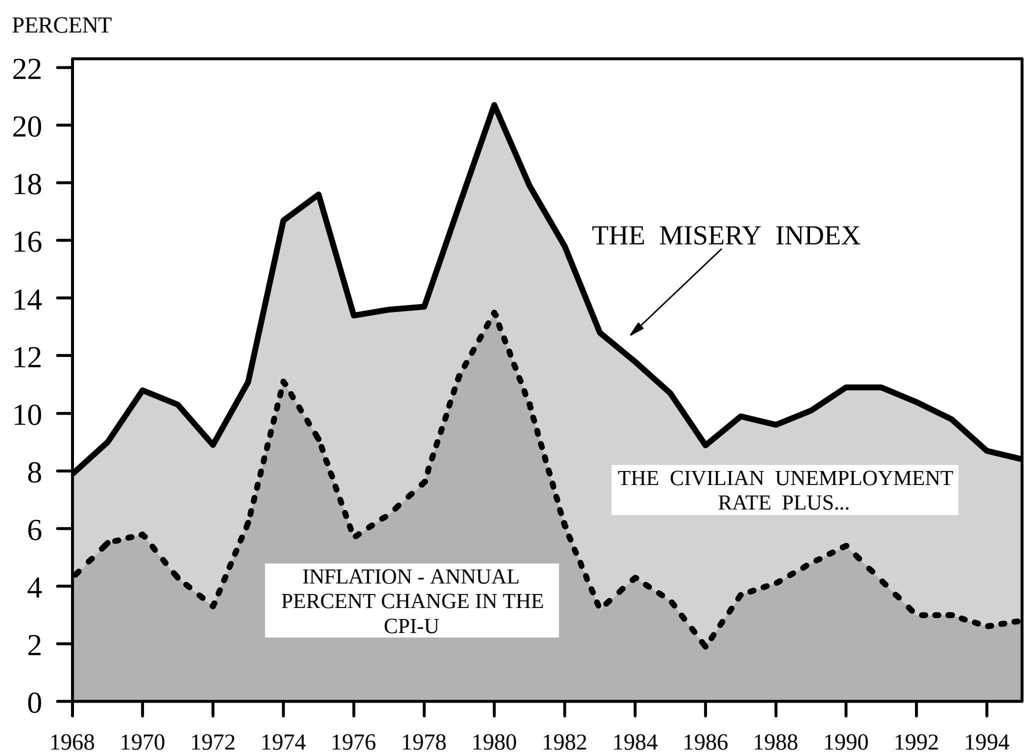
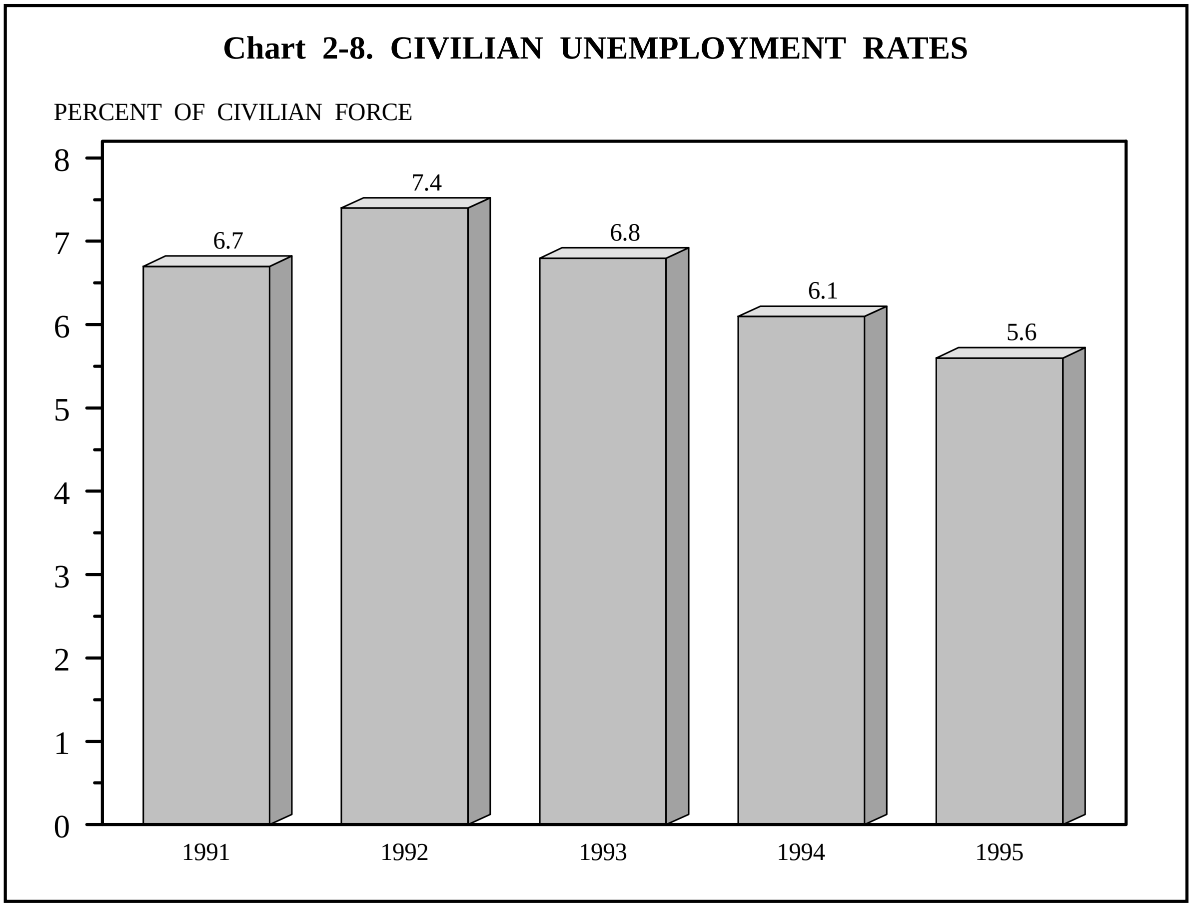


Chart 2-7. THE "MISERY" INDEX





Debt left the economy vulnerable when recession struck in the 1990s, and it helps explain why the recovery was initially so weak. No strong recovery could occur until the unwise policies of the 1980s were reversed.

The decline in saving and investment also contributed to another of the economy's chronic weaknesses—sluggish productivity growth.

The Productivity Slowdown: Rising productivity holds the key to higher incomes. For 25 years after World War II, productivity growth averaged 2.7 percent a year, the highest in U.S. history for that long a time period, and it reached three percent a year in the 1960s. Incomes rose substantially for most families, and workers grew accustomed to annual pay increases that outstripped inflation. The middle class expanded, as did opportunities for home ownership, education, and leisure.

Since the early 1970s, productivity has grown an average of only about one percent a year, about a third as fast as before (see Chart 2–6). With slower productivity growth, the rapid rise in living standards came to an end. The Nation's promise of opportunity was in danger and Americans began to fear that, for the first time in U.S. history, future generations would not enjoy higher living standards than their parents.

While the economy continued to grow, it did not grow as fast as in earlier decades. Moreover, growth depended more on the entry of new workers, especially married women, into the labor market. When growth in the labor force slowed, as at the beginning of the 1990s, productivity improvements alone could not sustain continued rapid increases in real GDP.

Rising Inequality: Another chronic problem, aggravated by slower productivity growth and lower saving, was rising income inequality. For the lowest 60 percent of American families, the standard of living actually fell from 1979 to 1992. Only those at the top continued to enjoy substantial income gains.

For families in the bottom 20 percent of income, real mean income was 14 percent lower in 1992 than in 1973; for families in the top five percent, real income was 17 percent higher. As a result, the gap between the top and bottom incomes widened to record levels.

The Social Repercussions

Slow productivity growth and widening income inequality have effects throughout society. The difficulties of working families in making ends meet have raised the pressures on them and weakened the social fabric. The consequences have come to light in the economic and social statistics on poverty, social breakdown, and crime.

The sluggish economy of the early 1990s was especially hard on the poor. The official poverty rate hit its low point in 1973, after falling sharply for most of the previous decade. Since then, increases in poverty during recessions have outpaced reductions in poverty during recoveries.

By 1992, the poverty rate had risen to nearly 15 percent. That year, more than one in five of the Nation's children were poor.

WHAT THE ADMINISTRATION HAS ACHIEVED

To bring the economy back to health, the Administration sought to tackle the budget deficit while promoting prosperity by investing in education and training, and science and technology; by opening new markets; and by keeping interest rates and inflation in check.

Budget Policy

The President and the last Congress enacted the Omnibus Budget and Reconciliation Act of 1993, designed to reduce the deficits by a combined $505 billion over five years, 1994–98. Because the economy has performed better than even the Administration had predicted, we now expect those deficits to fall by $697 billion over the same period, even without further steps to reduce them.

The President's 1993 economic plan, which still governs U.S. fiscal policy, achieved over half of its $505 billion of deficit reduction through spending cuts ($255 billion), and the rest through tax measures designed to increase the progressivity of the tax code and also raise revenue. It made deep cuts in discretionary spending and entitlement programs. It extended through 1998 the annual limits, or "caps," on discretionary spending that Congress first imposed in 1990. (This budget would extend them even further.) In addition, it cut entitlements by $98 billion.

Nevertheless, the President's plan also expanded the Earned Income Tax Credit (EITC), which rewards work for those in the lowest-income brackets. The EITC makes work pay. It offers a positive inducement to low-income families to enter the working world and avoid the cycle of dependency. The plan raised the rate of the EITC, expanded it to provide tax relief to more lower-income working families with children, and extended the credit to apply, at lower rates, to low-income workers without children.

In the 1993 plan, only one revenue increase affected typical American households—a 4.3 cent per gallon increase in the Federal excise tax on gasoline. The change was well timed; it occurred while gas prices were falling, so it imposed little or no extra burden on households. Moreover, the plan brought down interest rates, saving these typical households sizable sums on home mortgages and auto and other consumer loans.

All told, about 90 percent of the revenue increases came from households with incomes of over $100,000. To be sure, no one ever wants to raise taxes. But this change was appropriate—given the pressing need to cut the deficit, and given that high-income families prospered so much in the preceding decade. And with the plan at least partly responsible for growth in the economy and the stock market since 1993, these people have prospered in the last three years.

Largely due to the President's plan and the economic growth it helped spur, the deficit fell from $290 billion in 1992 to

$164 billion in 1995; we expect it to remain near this level through 1997. This Nation now has the smallest deficit, relative to the size of its economy, of any developed country in the world except Norway.

At the same time, even with total discretionary spending rising far less than inflation, the President has worked with Congress to reallocate funds to programs that invest in the future and, thus, spur economic growth. While the private sector plays the lead role in creating growth, the Federal Government must play a key supporting role.

Among other things, the President and Congress increased funding for Head Start; Goals 2000 educational reforms; college scholarships; dislocated worker assistance; research and technology; environmental protection; the national forests and parks; Clean Water and Safe Drinking Water revolving funds; community policing; and the operations of the FBI, the Immigration and Naturalization Service, and Federal prisons.

The President and Congress also created and funded the Americorps program that enables students to work in communities while earning funds for college; the Charter Schools program to support public school choice; the School-to-Work Opportunities Act to help young people make a smooth transition from high school to work; and the Federal Direct Student Loan program to make borrowing cheaper and more effective, and to ease the burden of repayment.

Economic Achievements

By addressing the deficit, the Administration helped resolve the economy's short-run problems. The President's plan enabled the Federal Reserve to maintain low interest rates throughout 1993, and financial markets responded by lowering long-term rates.

For example, the yield on ten-year Treasury notes fell from 6¾ percent in late 1992 to 5¾ percent by the end of 1993, helping to end the credit crunch. Interest rates have fluctuated since 1993, but with the fall in the deficit freeing up resources for private investment, investment has boomed ever since.

Real growth accelerated in 1993, but inflation remained firmly in check. Within two years, unemployment fell below six percent, producing the lowest combined rates of unemployment and inflation in three decades (see Charts 2–7 and 2–8).

Job Growth Up, Unemployment Down: Since January 1993, the economy has added 7.7 million net new jobs, an average of 214,000 a month (see Chart 2–9). Over seven million were in the private sector. Over half of the new jobs were in the high-paying professional or managerial categories. The economy created over a million new jobs in the basic industries of construction and manufacturing, including the bellwether automobile industry.

Economic Growth Up: Also since January 1993, real GDP has risen at a 2.6 percent annual rate, roughly triple the average growth rate of the prior three years and faster than such economies as Japan's and Germany's (see Charts 2–10 and 2–11). Since the first quarter of 1993, private sector GDP—excluding government—has grown by 3.2 percent a year.

Inflation Under Control: The Consumer Price Index has risen an average of just 2.7 percent a year since January 1993, marking the smallest three-year rise since the mid-1960s (see Chart 2–12).

Interest Rates Down: In the President's first year, long-term interest rates paid by home buyers, business investors, and the Government fell by over a point. Inflation fears temporarily reversed that drop in 1994, but interest rates fell again in 1995 as inflation fears proved unwarranted and chances for more deficit reduction rose. By the end of 1995, long-term rates were down a full point from their levels of January 1993. Aside from a few months in 1993, long-term rates were at their lowest point since the 1960s (see Chart 2–13).

Household Wealth Up: Lower interest rates improved the financial standing of households by making home ownership more affordable and boosting the stock market. The home ownership rate rose to 65.1 percent by the end of 1995, its highest since 1981. Meanwhile, the stock market has given its strong endorsement on the state of the economy. Since January 1993, the Dow-Jones Industrial average has risen by over 60 percent, with 36 percent of the rise coming in 1995. All other major stock

Chart 2-9. JOB CREATION

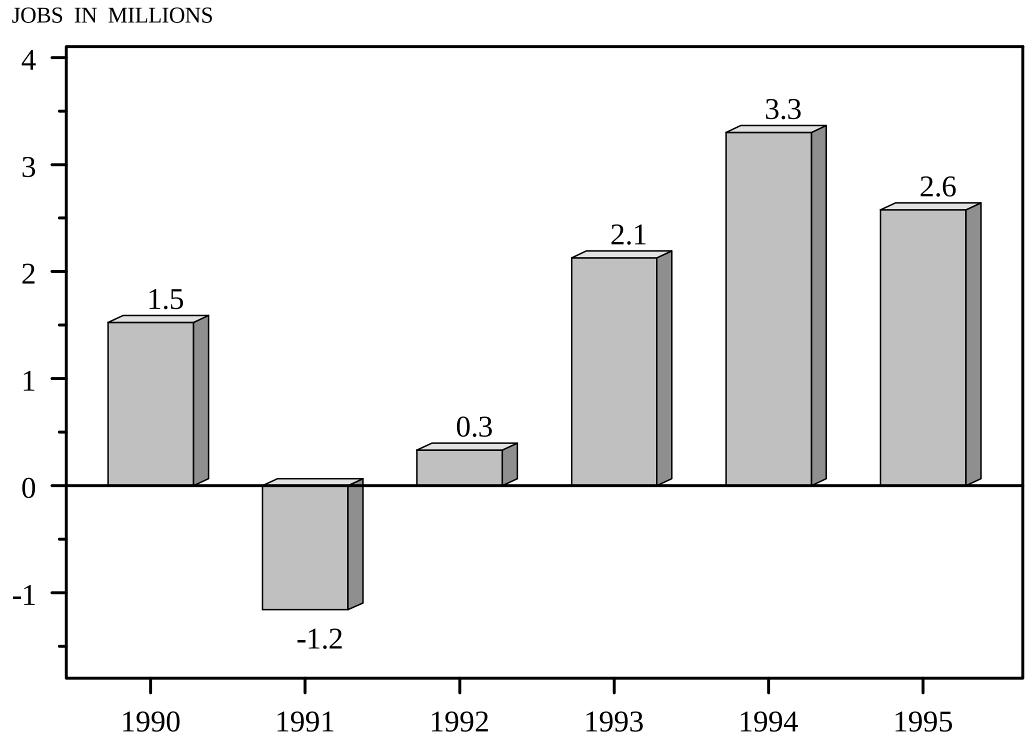
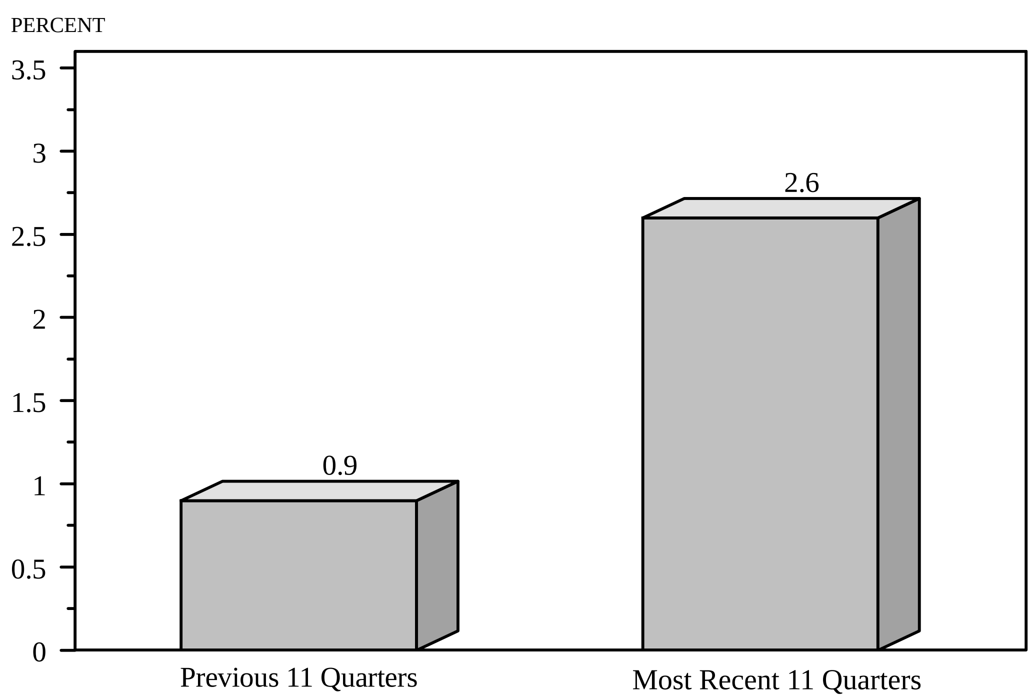


Chart 2-10. ECONOMIC GROWTH

(average annual growth rate of real GDP)



market indexes were up by corresponding amounts.

Exports Up: U.S. exports of goods and services have risen at a rapid 7.6 percent annual rate (after adjusting for inflation) since the first quarter of 1993. Merchandise exports have risen even quicker, at a 9.6 percent rate. The export record is particularly impressive in light of the anemic growth in some of the other major industrialized countries.

With other economies growing more slowly than America's, our imports should have grown faster than our exports. They did. Consequently, the trade deficit rose through the first half of 1995. But, as the gap in economic growth narrowed a bit in the second half of the year, so did the deficit—it fell between June and December of 1995, from $11.4 billion to $6.8 billion. The bilateral deficit with Japan dropped from an annual rate of $64.7 billion in the first half of 1995 to $56.3 billion in the second half.

Progress Against Unfavorable Long-Term Trends

As we have seen, the economy as a whole has improved markedly in the last three years. To be sure, we face the ongoing challenge of addressing the fundamental factors that determine long-term prosperity. Even for those, however, various signs of progress appeared in 1994, the last year for which statistics are available.

That year, median family income rose while the poverty rate—and, importantly, the poverty rate for children—fell. Real incomes grew in all five quintiles of the income scale for the first time in five years (see Chart 2–14).

Further improvement may have occurred last year, given the favorable levels of unemployment and growth in real income. The President's program is designed to do even more by creating opportunity and encouraging responsibility (see Chapters 5 through 12)

Chart 2-11. COMPARATIVE GROWTH RATES

(average annual growth rates of real GDP, Q4/1992 to Q2/1995)

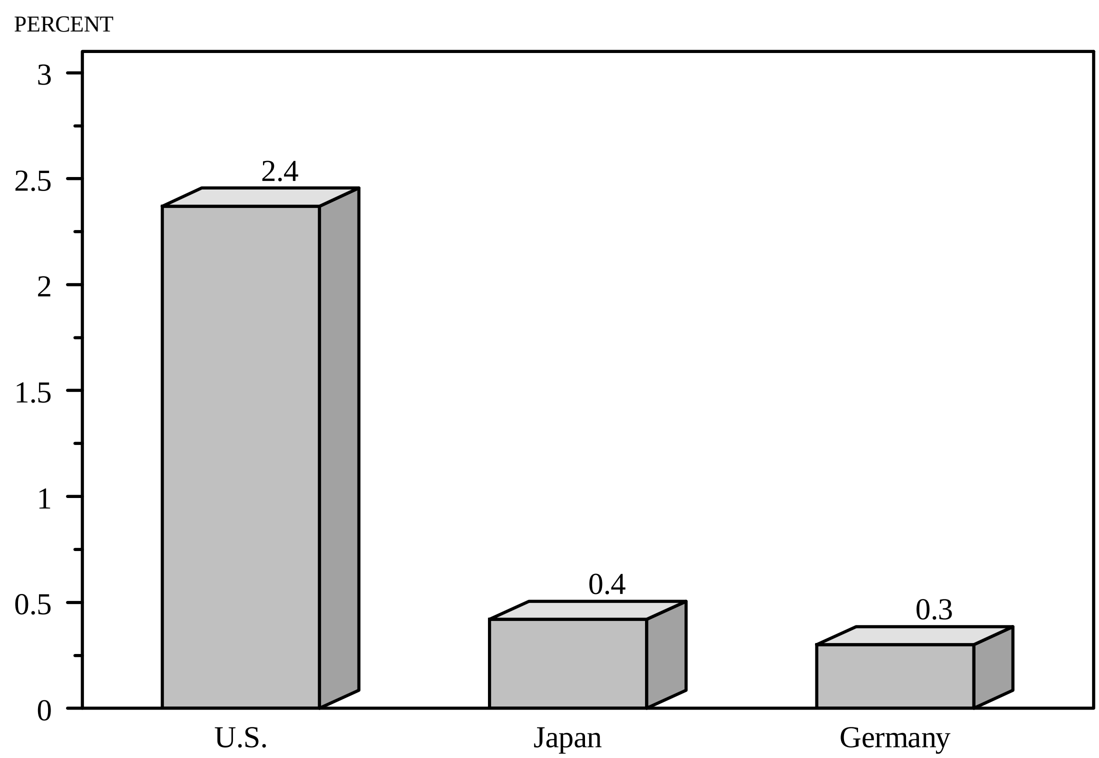
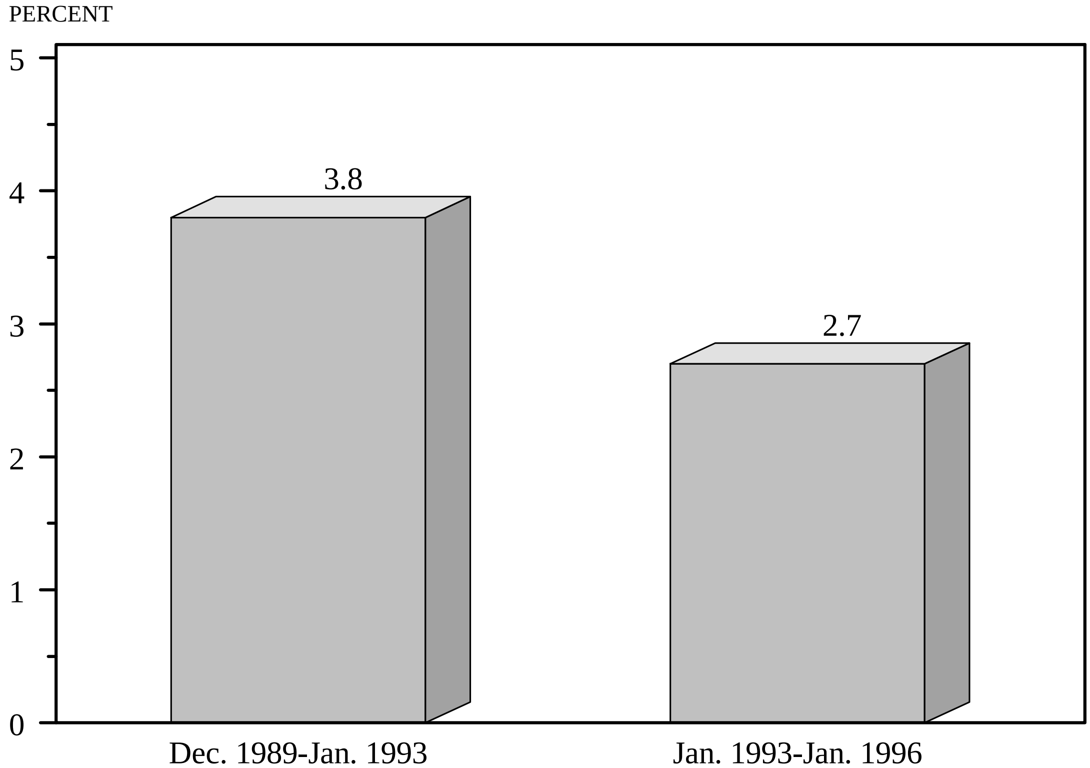


Chart 2-12. INFLATION
(average annual change in the Consumer Price Index, or CPI)



and providing tax relief to millions of middle-income families (see Chapter 12).

Productivity growth has only begun to rise, and the final pay-off of deficit reduction has not yet arrived. But the fundamental economic changes are in the right direction.

In the coming years, the saving and investment boom of the last three years will generate higher incomes by enabling workers to produce and earn more. In the near term, the main effect of higher investment has been to lower unemployment—itself an early step toward greater prosperity.

A PRUDENT LOOK AT THE ECONOMIC FUTURE

In its economic assumptions, the Administration projects a continuation of current favorable economic conditions. The assumptions are reasonable and conservative.[1]

Specifically, they project:

- Real GDP growth (on the new chain-weighted basis [2]) that averages 2.3 percent a year through 2002, in line with private forecasters and CBO—about a half-point a year less than what the Administration has achieved over the last three years;
- The unemployment rate to remain stable at 5.7 percent, close to its current level and within the range that it has maintained for over a year;

[1] For a more detailed explanation of the Administration's economic assumptions, see *Analytical Perspectives*, Chapter 1.

[2] The Government now measures growth on the new basis that the Bureau of Economic Analysis introduced in January 1996.

Chart 2-13. LONG-TERM INTEREST RATES

(average yield on 10-year Treasury Notes)

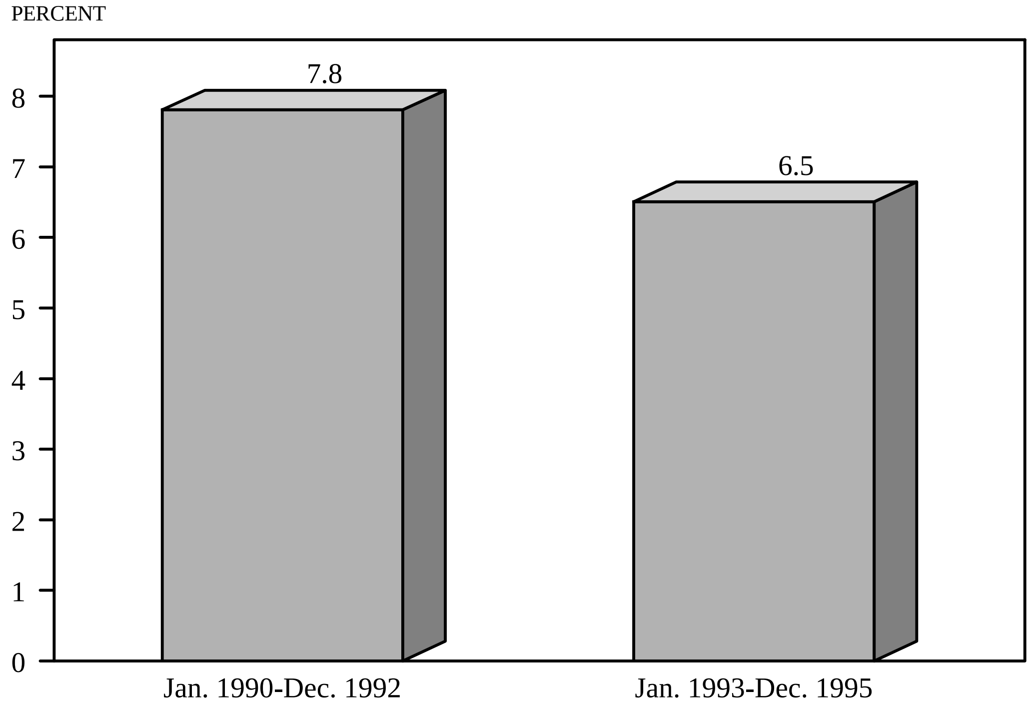
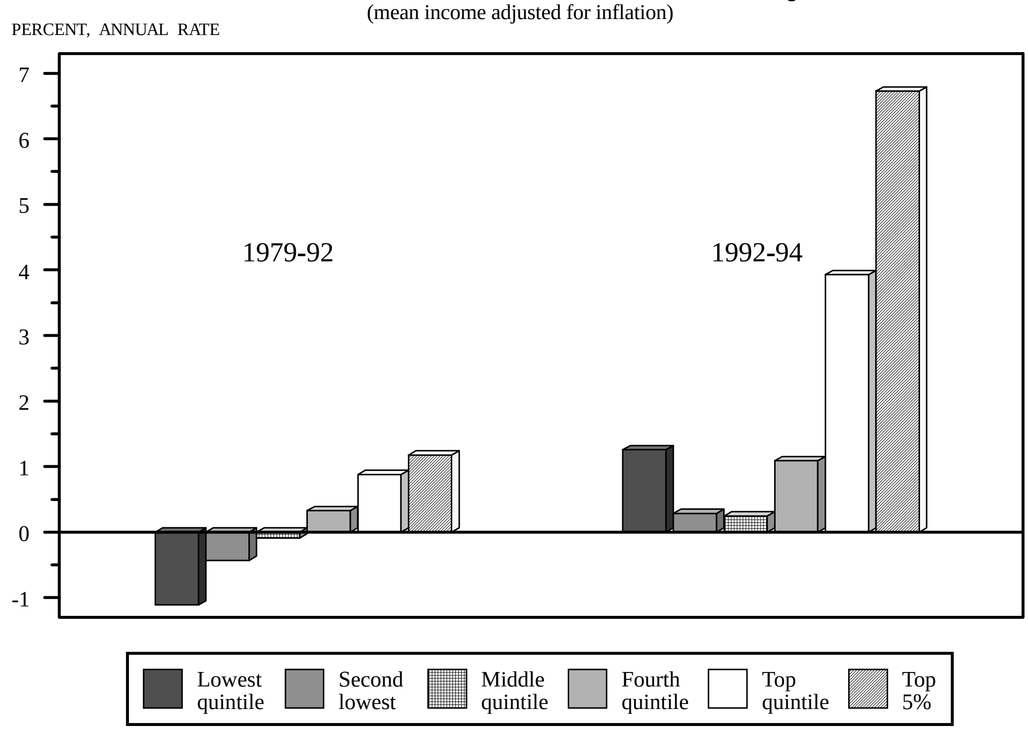


Chart 2-14. AVERAGE FAMILY INCOME BY QUINTILE

(mean income adjusted for inflation)



Source: Bureau of the Census.

- An increase in the CPI of about 2.8 percent a year from 1998 to 2002, about the same as it averaged in the previous three years; and
- The 10-year Treasury bond rate to fall by 1.1 percentage points over the next four years as the deficit continues to decline. Over the past year, the rate has fallen by two percentage points.

These economic assumptions presume that Congress adopts the President's proposals—most fundamentally that the President and Congress put the budget on a path to balance by 2002—and that the progress will be evident to households, businesses, and investors. For this reason, the Administration expects to see declines in interest rates, stimulating sustained growth and investment.

Table 2–1. ECONOMIC ASSUMPTIONS [1]

(Calendar years; dollar amounts in billions)

	1994 Actual	Projections							
		1995	1996	1997	1998	1999	2000	2001	2002
Gross Domestic Product (GDP):									
Levels, dollar amounts in billions:									
Current dollars	6,931	7,254	7,621	8,008	8,417	8,848	9,295	9,772	10,268
Real, chained (1992) dollars	6,604	6,742	6,888	7,047	7,212	7,380	7,553	7,730	7,911
Chained price index (1992 = 100), annual average	105.0	107.6	110.6	113.6	116.7	119.9	123.1	126.4	129.8
Percent change, fourth quarter over fourth quarter:									
Current dollars	5.9	4.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Real, chained (1992) dollars	3.5	1.5	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Chained price index (1992 = 100), annual average	2.3	2.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7
Percent change, year over year:									
Current dollars	5.8	4.7	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Real, chained (1992) dollars	3.5	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Chained price index (1992 = 100), annual average	2.3	2.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7
Incomes, billions of current dollars:									
Personal income	5,750	6,104	6,416	6,716	7,025	7,337	7,664	8,031	8,434
Wages and salaries	3,241	3,420	3,607	3,801	3,995	4,193	4,403	4,629	4,864
Corporate profits before tax	528	602	650	702	753	800	843	882	917
Consumer Price Index (all urban): [2]									
Level (1982–84 = 100), annual average	148.2	152.4	156.6	161.3	165.9	170.5	175.3	180.2	185.2
Percent change, fourth quarter over fourth quarter	2.6	2.7	3.1	2.9	2.8	2.8	2.8	2.8	2.8
Percent change, year over year	2.6	2.8	2.8	3.0	2.8	2.8	2.8	2.8	2.8
Unemployment rate, civilian, percent:									
Fourth quarter level	5.6	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Annual average	6.1	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Federal pay raises, January, percent:									
Military	2.2	2.2	2.6	3.0	3.1	3.1	3.1	3.1	3.1
Civilian [3]	....	2.0	2.0	3.0	NA	NA	NA	NA	NA
Interest rates, percent:									
91-day Treasury bills [4]	4.3	5.5	4.9	4.5	4.3	4.2	4.0	4.0	4.0
10-year Treasury notes	7.1	6.6	5.6	5.3	5.0	5.0	5.0	5.0	5.0

NA = Not available.

[1] Based on information available as of mid-January 1996.

[2] CPI for all urban consumers. Two versions of the CPI are 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.

[3] Percentages for 1994–1996 exclude locality pay adjustments. Percentages to be proposed for years after 1997 have not yet been determined.

[4] Average rate (bank discount basis) on new issues within period.