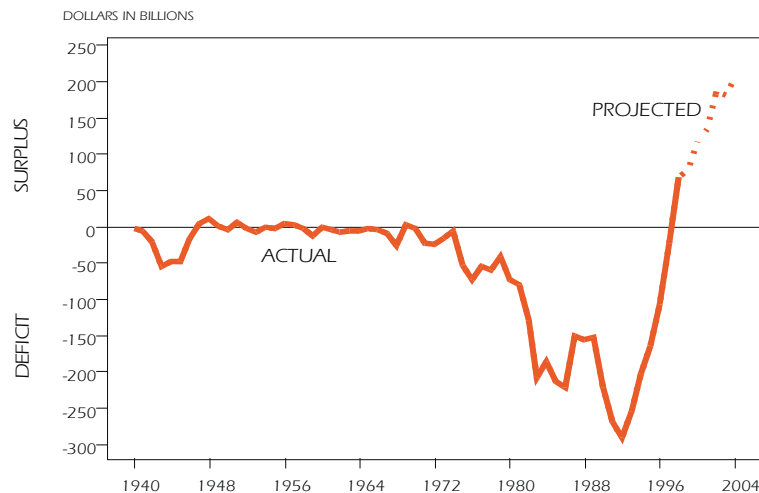


4. The Budget Surplus and Fiscal Discipline

In 1998 the Federal budget reported a surplus of \$69 billion, the first surplus since 1969, and reduced Federal debt held by the public by over \$50 billion. With continued prudent fiscal policies, the budget can remain in surplus for many years. The turnaround from deficit to surplus can be attributed to fiscal discipline and strong economic growth. The change from deficit to surplus is an important milestone.

Put simply, a surplus occurs when revenues exceed spending in any year—just as a deficit occurs when spending exceeds revenues. Generally, to finance

Chart 4-1. Past and Future Budget Deficits or Surplus



Deficits began increasing dramatically in the 1980s, but have now been reversed.

past deficits, the Treasury has borrowed money. With certain exceptions, the *debt* is the sum total of our deficits, minus our surplus, over the years.

The Government incurred its first deficit in 1792, and it generated 70 annual deficits between 1900 and 1997.

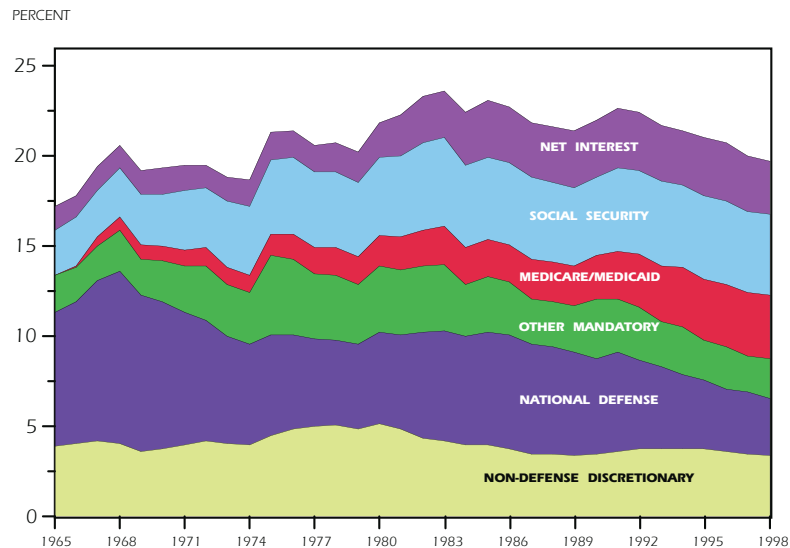
Chart 4-1 provides the history of budget surplus and deficits since 1940.

For most of the Nation's history, deficits were the result of either wars or recessions. Wars necessitated major increases in military spending, while recessions reduced Federal tax revenues from businesses and individuals.

The Government generated deficits during the War of 1812, the recession of 1837, the Civil War, the depression of the 1890s, and World War I. Once the war ended or the economy began to grow, the Government followed its deficits with budget surplus, with which it paid down the debt.

Deficits returned in 1931 and remained for the rest of the decade—due to the Great Depression and the spending associated with President Roosevelt's New Deal. Then, World War II forced the Nation to spend unprecedented amounts on defense and to incur corresponding unprecedented deficits.

Chart 4-2. Outlays as a Percent of GDP



Between 1965 and 1998, spending on Social Security, Medicare and Medicaid, and interest as a percentage of GDP grew, while spending on defense fell.

Since then—with Democratic and Republican Presidents, Democratic and Republican Congresses—the Government has balanced its books only nine times, most recently last year.

Nevertheless, the deficits before 1981 paled in comparison to what followed. That year, the Government cut income tax rates and greatly increased defense spending, but it did not cut non-defense programs enough to make up the difference. Also, the recession of the early 1980s reduced Federal revenues, increased Federal outlays for unemployment insurance and similar programs that are closely tied to economic conditions, and forced the Government to pay interest on more national debt at a time when interest rates were high. As a result, the deficit soared.

Why have we been able to move from deficit to surplus? Because spending growth has been restrained. Outlays are growing slower and revenues are holding steady.

Revenues have stayed relatively constant, at around 17 to 21 percent of GDP, since the 1960s. In that time, however, outlays grew from about 17 percent of GDP in 1965 to nearly 24 percent in 1983 before falling below 20 percent today.

Since 1983, spending had been reduced or held constant as percent of GDP across a wide variety of programs. The most significant reduction has occurred in discretionary spending, which has fallen from 10.3 percent to 6.6 percent of GDP. Combined spending on social security and net interest has remained roughly constant at about 7-1/2 percent of GDP since 1983. A similar path has been followed in the rest of mandatory spending in total, but only because the growth in Medicare and Medicaid has been offset by declines in other mandatory spending (see Chart 4-2).

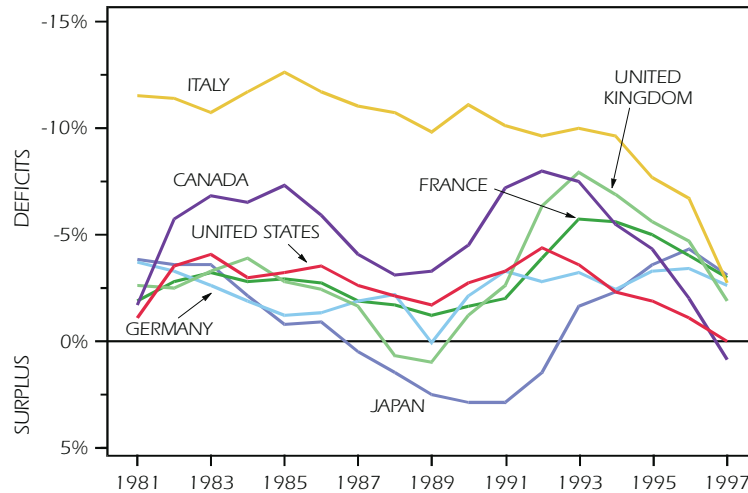
Why a Budget Surplus is Important

As Chart 4-3 illustrates, this Nation has a good record when compared to the recent history of the six other major developed economies. (To make accurate comparisons with the governments of other nations, the U.S. data include the activities of State and local governments.)

Should we worry about the possibility of a return to budget deficits?

The 2000 Budget forecasts surplus for decades to come, if we maintain the policy of fiscal discipline and strategic investments in the American people.

Chart 4-3. Total Government Surplus or Deficit as a Percent of GDP



Source: OECD, calendar year data.

Of the seven nations shown above, only the United States and Canada eliminated their total Government budget deficits in 1997.

We must do all we can to keep the days of deficits in the past. Budget deficits force the Government to borrow money in the private capital markets. That borrowing competes with (1) borrowing by businesses that want to build factories and machines that make workers more productive and raise incomes, and (2) borrowing by families who hope to buy new homes, cars, and other goods. The competition for funds tends to produce higher interest rates.

Deficits increase the Federal debt and, with it, the Government's obligation to pay interest. The more it must pay in interest, the less it has available to spend on education, law enforcement, and other important services, or the more it must collect in taxes—forever after. As recently as 1997, the Government spent over 15 percent of its budget to pay interest, in contrast to a projected 12 percent for 2000. Continuing surplus will reduce these interest payments further in future years.

In the end, the surplus is a decision about our future. We can provide a solid foundation for future generations, just as parents try to do within a family. For a Nation, this means a strong economy and low interest rates and debt. Alternatively, we can generate large deficits and debt for those who come after us.

Surplus and Debt

If the Government incurs a surplus, it generally repays debt held by the public.

Table 4–1 summarizes the relationship between the budget surplus or deficit and the repayment of Federal debt.

Federal borrowing involves the sale, to the public, of notes and bonds of varying sizes and time periods until maturity. The cumulative amount of borrowing from the public—i.e., the debt held by the public—is the most important measure of Federal debt because it is what the Government has borrowed in the private markets over the years, and it determines how much the Government pays in interest to the public.

Debt held by the public was \$3.7 trillion at the end of 1998—roughly the net effect of deficits and surplus over the last 200 years. Debt held by the public does not include debt the Government owes itself—the total of all trust fund surplus and deficits over the years, like the Social Security surplus, which the law says must be invested in Federal securities.

Because of the progress in eliminating the budget deficit, the debt held by the public has been reduced for the first time in 29 years.

Table 4–1. Federal Government Financing and Debt

	(in billions of dollars)						
	1998	Estimate					
	Actual	1999	2000	2001	2002	2003	2004
Federal Government financing:							
Budget surplus	69	79	117	134	187	182	208
Other means of financing	–18	–29	–19	–17	–17	–16	–15
Repayment of debt held by the public	51	50	98	117	170	166	193
Federal Government debt:							
Debt held by the public	3,720	3,670	3,572	3,455	3,285	3,119	2,926
Debt held by government accounts	1,759	1,945	2,140	2,326	2,530	2,736	2,948
Gross Federal debt	5,479	5,615	5,711	5,781	5,815	5,856	5,874
Debt subject to legal limit	5,439	5,577	5,674	5,745	5,780	5,821	5,842

Note: Numbers may not add to the totals because of rounding.

The sum of debt held by the public and debt the Government owes itself is called Gross Federal Debt. At the end of 1998, it totaled \$5.5 trillion.

Another measure of Federal debt is debt subject to legal limit, which is similar to Gross Federal Debt. When the Government reaches the limit, it loses its authority to borrow more to finance its spending; then, the President and Congress must enact a law to increase the limit. Because the budget has returned to surplus and debt is being reduced, there will be no need to increase the statutory limit in 2000.

The Government's ability to finance its debt is tied to the size and strength of the economy, or GDP. Debt held by the public was 44 percent of GDP at the end of 1998. As a percentage of GDP, debt held by the public was highest at the end of World War II, at 109 percent, then fell to 24 percent in 1974 before gradually rising to a peak of 50 percent in the middle 1990s.

That decline, from 109 to 24 percent, occurred because the economy grew faster than the debt accumulated; debt held by the public rose from \$242 billion to \$344 billion in those years, but the economy grew faster.

Individuals and institutions in the United States hold two-thirds of debt held by the public. The rest is held in foreign countries.

Returning the Budget to Surplus

Ever since the deficit soared in the early 1980s, successive Presidents and Congresses have tried to cut it. Until recently, they met with only limited success.

In the early 1980s, President Reagan and Congress agreed on a large tax cut, but could not agree about cutting spending; the President wanted to cut domestic spending more than Congress, while Congress sought fewer defense funds than the President wanted. They wound up spending more on domestic programs than the President wanted, and more on defense than Congress wanted. At the same time, a recession led to more spending to aid those affected by the recession, and reductions in tax revenues due to lower incomes and corporate profits.

By 1985, both sides were ready for drastic measures. That year, they enacted the Balanced Budget and Emergency Deficit Control Act. It set annual deficit targets for five years, declining to a balanced budget in 1991. If necessary, GRH required across-the-board cuts in programs to comply with the deficit targets.

Faced with the prospect of huge spending cuts in 1987, however, the President and Congress amended the law, postponing a balanced budget until 1993. The President and Congress never achieved those revised targets, in part because of the extraordinary costs of returning the Nation's savings and loan industry to a sound financial footing.

By 1990, President Bush and Congress enacted spending cuts and tax increases that were designed to cut the accumulated deficits by about \$500 billion over five years. They also enacted the Budget Enforcement Act (BEA)—rather than set annual deficit targets. The BEA was designed to limit discretionary spending while ensuring that any new entitlement programs or tax cuts did not make the deficit worse.

First, the BEA set annual limits on total discretionary spending for defense, international affairs, and domestic programs. Second, it created “pay-as-you-go” rules for entitlements and taxes: those who proposed new spending on entitlements or lower taxes were forced to offset the costs by cutting other entitlements or raising other taxes.

For what it was designed to do, the law worked. It did, in fact, limit discretionary spending and force proponents of new entitlements and tax cuts to find ways to finance them. But the deficit, which Government and private experts said would fall, actually rose.

Why? Because the recession of the early 1990s reduced individual and corporate tax revenues and increased spending that is tied to economic fluctuations. Federal health care spending also continued to grow rapidly.

In 1993, President Clinton and the Congress made another effort to cut the deficit. They enacted a five-year deficit reduction package of spending cuts and higher revenues. The law was designed to cut the accumulated deficits from 1994 to 1998 by about \$500 billion. The new law extended the limits on discretionary spending and the “pay-as-you-go” rules.

Although the 1993 plan exceeded all expectations in reducing the deficit, the task of reaching balance would require one final push. That would come with the historic 1997 Balanced Budget Act (BBA).

Originally designed to balance the budget by 2002, the BBA provided for \$247 billion in savings over five years. It also extended the solvency of Medicare's trust fund for at least 10 years while providing for the largest investment in higher education since the G.I. Bill in 1945, the largest investment in children's health care since the creation of Medicaid in 1965, and a \$500-per-child tax credit for about 27 million working families.

Clearly, the President's deficit reduction efforts have paid off. The deficit fell from \$290 billion in 1992 to a surplus of \$69 billion in 1998.

The President is now proposing to reserve the surplus until Social Security is reformed. His plan for reform uses 62 percent of the projected unified budget surplus of the next 15 years to put the Social Security system on sound financial footing well into the next century. In 2000 the challenge for both the President and the Congress is to maintain fiscal discipline and reach comprehensive Social Security reform while continuing to invest in the American people. The next chapter describes the President's plans for achieving that goal.