II. THE TURNAROUND IN THE BUDGET AND THE ECONOMY

II. THE TURNAROUND IN THE BUDGET AND THE ECONOMY

This section reviews the budgetary and economic performance of the Clinton-Gore Administration, comparing conditions now with those when President Clinton took office. Over the past eight years, the budget has turned from record deficits to record surpluses; the resultant increase in national saving supported sharply rising investment, accelerating productivity, and the longest economic expansion in history. Moreover, the substantial improvement in the budget has set the Federal Government on a path to be debt-free by the end of this decade.

The Clinton-Gore Economic Strategy

President Clinton was elected with the goal of revitalizing the economy. When he took office in January 1993, the economy was slowly emerging from the 1990–1991 recession, with an unemployment rate of 7.5 percent. He proposed a three-part economic strategy: fiscal discipline to free resources for private investment; increased support for investment in our people, including education, health care, and research; and engagement in the international economy, to open markets abroad to our products and services. In the last eight years, this Administration has completed hundreds of agreements that increase our access to foreign markets, and has expanded public human and infrastructure investment (as documented elsewhere in this volume). Furthermore, the Administration's new budget policy was enacted in 1993, and it has proven a great success.

The budget deficit, which had reached a record $290 billion in 1992, has steadily fallen, until in 1998 there was a budget surplus for the first time in 29 years. The budget is projected to end the current fiscal year with a surplus of $256 billion—the fourth year in a row of surplus, for the longest period of budget surpluses since the 1920s; and by far the longest string of consecutive years of budget improvement in our Nation's history.

The turnaround in the budget supported a remarkable turnaround in the economy. Financial markets responded to the shift from deficits to surpluses by reducing long-term interest rates. Real interest rates (actual market rates minus expected inflation) were about 1.2 percentage point lower on average under this Administration than they were during the previous 12 years. Lower real interest rates stimulated more business investment, leading to rising productivity, higher profits, and increased real wages. The average rate of economic growth accelerated to 4.0 percent per year.

The investment boom strengthened and prolonged the economic expansion, which by February 2000 had become the longest in U.S. history. This February, it will complete its tenth year. President Clinton is the first two-term President to leave office without enduring a recession. The past eight years were an extraordinary combination of low inflation, falling unemployment, soaring productivity, rising real wages, and declining poverty—which continued into the new millennium.

Budgetary Performance

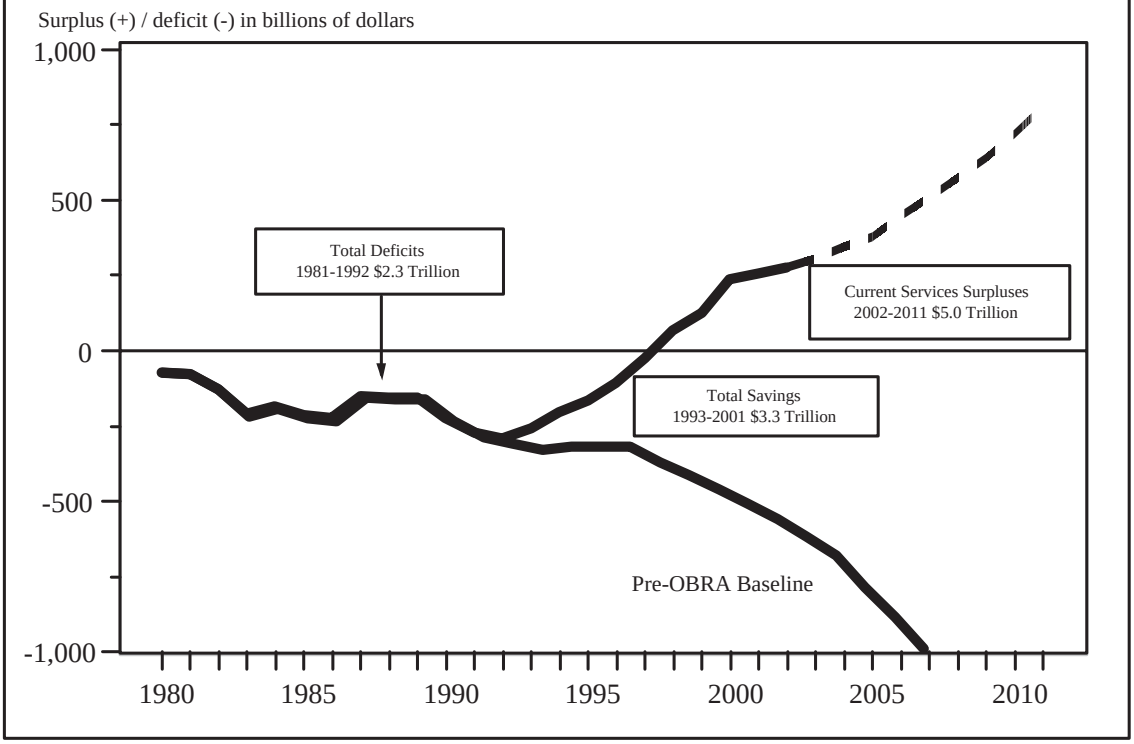
Before 1993, 12 years of burgeoning budget deficits had quadrupled the amount of Federal debt held by the public—an increase of $2.3 trillion. Relative to the size of the economy, the debt almost doubled—rising from 26 percent of Gross Domestic Product (GDP) in 1980 to 48 percent in 1992. The Administration's first priority was to cut the massive deficit (and thus slow the rise in Federal debt). To accomplish that, the Administration proposed, and the Congress enacted, the Omnibus Budget Reconciliation Act (OBRA) of 1993. It was a crucial step toward fiscal responsibility. The Administration expected OBRA to reduce the deficit significantly; but the actual improvement in the budget far exceeded these expectations. To finally eliminate the budget deficit, the President

and the Congress agreed to the bipartisan Balanced Budget Act (BBA), enacted in 1997, which set a goal of a balanced budget by 2002. In 1998, the budget went into surplus four years ahead of schedule, accelerated by stronger-than-projected economic growth.

Deficit Reduction Was Augmented by its Favorable Economic Effects: The cumulative results of OBRA and the BBA were a stunning turnaround. The Administration originally projected that OBRA would reduce the deficit by a cumulative $505 billion from 1994 through 1998. In fact, the total deficit reduction over this period was more than twice as large—$1.2 trillion (and $3.3 trillion from 1993 through 2001) as long-term fiscal discipline proved its value by accelerating economic growth (see Chart II–1). As financial markets saw that the risk of exploding future deficits and Federal borrowing would truly decline, they brought market interest rates down—reducing the deficit directly, but more importantly, reducing the cost of capital to businesses, and stimulating investment and growth.

Government Debt Was Reduced: When the Government runs a deficit, it borrows from the public and accumulates debt. The huge deficits incurred to pay for World War II pushed the publicly held Federal debt to a peak of 109 percent of GDP in 1946. For many years thereafter, the economy grew faster than the debt; and the ratio of the debt to the GDP gradually fell to a low of around 25 percent in the mid-1970s. The exploding deficits of the 1980s reversed this trend, and sent the debt back up—until it peaked at almost 50 percent of GDP in 1993. Had the Clinton-Gore Administration done nothing, both OMB and the Congressional Budget Office (CBO) had projected that publicly held Federal debt would have approached $7 trillion (or 75 percent of GDP) by 2002, and would have risen even further thereafter. Instead, the Administration's deficit reduction policy cut the ratio of debt to GDP immediately; and the budget surpluses

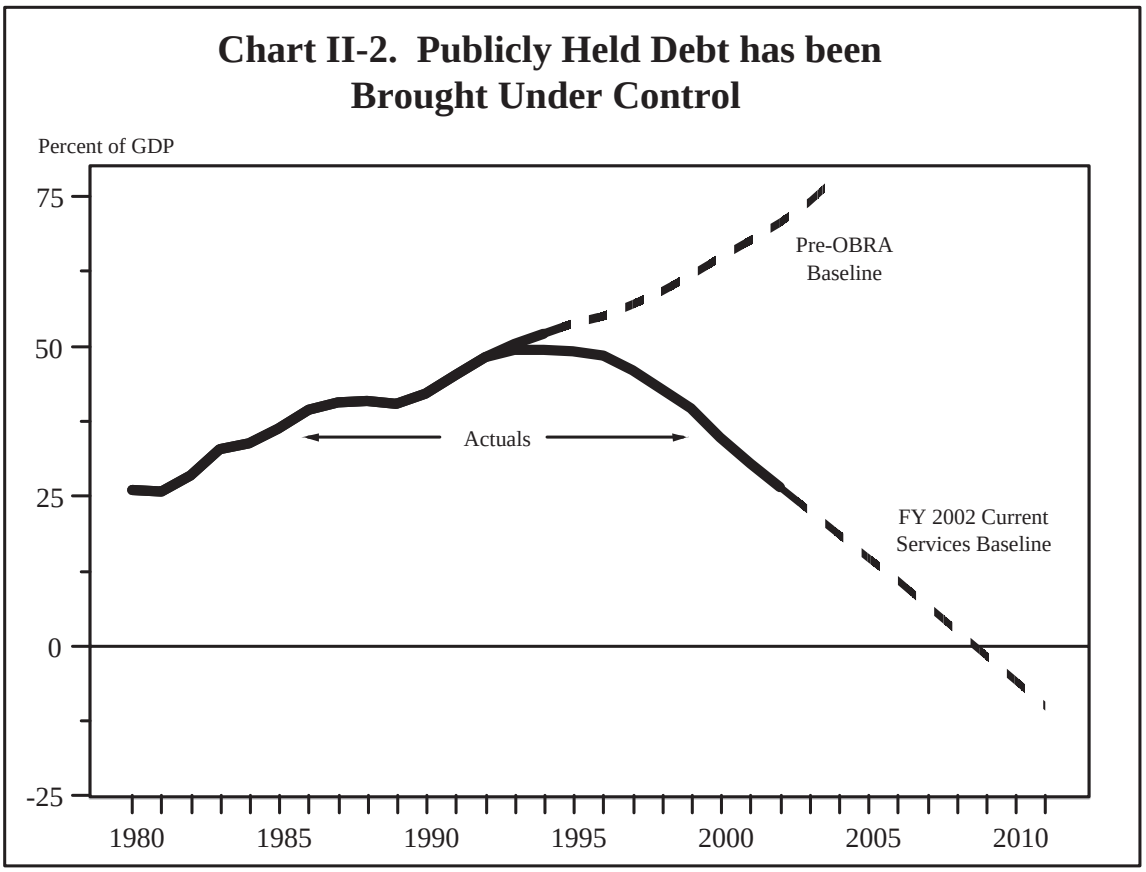
Chart II-1. Unified Budget Surpluses Follow Years of Deficits



since 1998 have actually reduced the dollar amount of debt, and driven the debt to GDP ratio down even faster. The ratio of publicly held debt to GDP in 2000 was 30 percentage points lower than was projected as of 1993, based on the policies before the Administration's budget plan.

Moreover, the pay-down in debt in the past three years ($363 billion) and the expected amount this year ($237 billion) combine to a $600 billion debt reduction—the largest four-year debt pay-down ever. As Chart II–2 shows, this substantial reduction and the prospect of continuing surpluses have put the debt held by the public on a trajectory that can eliminate the Federal Government's debtor status by the end of this decade.

There Are Now Unified, Social Security, and On-Budget Surpluses: The unified budget has been the most common framework for tallying the Federal Government's deficits and surpluses. The unified budget counts all Government receipts and spending (including Social Security contributions and benefits). This is the appropriate budget concept to evaluate how the Federal Government's activities affect the economy; obviously, for that purpose, it is essential to leave nothing out. The improvement in this overall budget surplus is shown in Chart II–1, and its effect on bringing down debt held by the public is shown in Chart II–2. Also, each of the major components of the unified budget is in surplus: the off-budget surplus—the excess of Social Security receipts over benefit payments, and the relatively small amount of transfers to or from the United States Postal Service—has increased from $45 billion to $158 billion between 1993 and 2001; and the on-budget balance—the rest of the unified budget—has swung from a $300 billion deficit to a $98 billion surplus (see Chart II–3). The Medicare surplus (which this Administration has proposed to move off-budget to protect that vital program's Trust Fund) has grown as well—from $4 billion in 1993 (and small



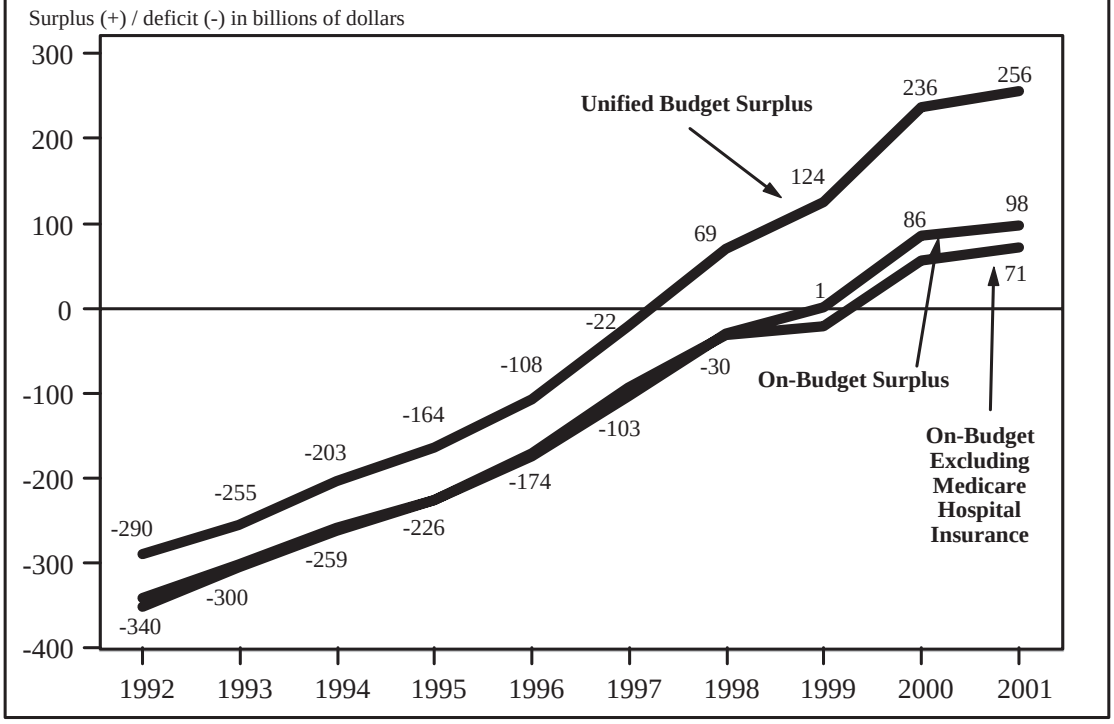
deficits from 1995 through 1997) to $27 billion in 2001.

A crucial part of the Clinton-Gore Administration's policy has been to save and protect the Social Security surpluses. The larger balances in the Social Security Trust Funds, and the interest that they earn, can finance Social Security benefits further into the future. Balances are currently invested in Federal securities—the most secure asset available. If Trust Fund assets were to be partly invested in private market instruments—such as stocks and bonds, rather than Federal debt—then the return earned by the Trust Fund could be somewhat higher, on average, over long periods. However, though the allocation of gross Federal debt between debt in the Trust Funds and debt held by the public would change, the total amount of gross debt would not change. The buildup of assets in the Trust Funds will correspond to a real increase in national wealth, and enhance the Government's ability to pay future benefits, only if it is saved by reducing the publicly held debt. This can be ensured if the Social Security surplus is protected by keeping the non-Social Security budget (approximately equal to the "on-budget") at least in balance. The consistent swing of the on-budget from deficit into surplus in this Administration has done just that.

As is clear from Chart II–3, the shift from unified budget deficit to surplus was mainly due to the elimination of the on-budget deficit. But whichever framework is used, the Federal Government's fiscal position since President Clinton took office has improved dramatically.

Government's Claim on the Economy Was Reduced while Prosperity Spurred Receipts: Federal spending reached the highest share of the economy since World War II in the 1980s; it was still 22.2 percent of GDP in 1992. The defense buildup in the early 1980s, higher Federal interest payments

Chart II-3. On-Budget Deficits have been Turned into Surpluses



because of increased debt and high interest rates, and large cost increases in Federal health programs overwhelmed all deficit-cutting efforts. This spending share turned down under President Clinton—even while the Administration increased Government investments in education, health care, the environment, and other priorities. In the last eight years, the ratio of Federal spending to GDP has steadily declined; in 2000 it was down to 18.2 percent, the lowest since the 1960s. At the same time, a healthy economy plus a strong stock market raised Federal tax receipts. Though tax burdens on most families have declined, the share of Federal receipts in GDP rose from 18.5 percent in 1995 to 20.6 percent in 2000—because of the rapid growth of incomes. Some of this increase may prove temporary; the Treasury Department estimates that receipts will decline to about 19.7 percent of GDP over the course of this decade—again, with no increase in tax rates (see Chart II–4).

The United States Has Become a World Leader in Budgetary Performance: In the 1980s, world opinion often faulted the United States for its large budget deficits, which were believed to have raised worldwide interest rates and hampered economic growth. The Clinton-Gore Administration's fiscal policy changed this criticism to praise, as the United States became a leader among the G-7 countries. In 2001, the United States is projected to have the largest budget surplus as a share of its economy (see Chart II–5). This outstanding performance came not from higher tax rates, but from spending restraint. Though the United States supports the world's largest defense establishment, it still has the G-7's lowest public spending and taxes as percentages of GDP.

Economic Performance

Government does not make the economy grow; the private sector is the engine of economic growth. The American people have

Chart II-4. The Budget was Balanced by Lower Spending and Increases in Receipts

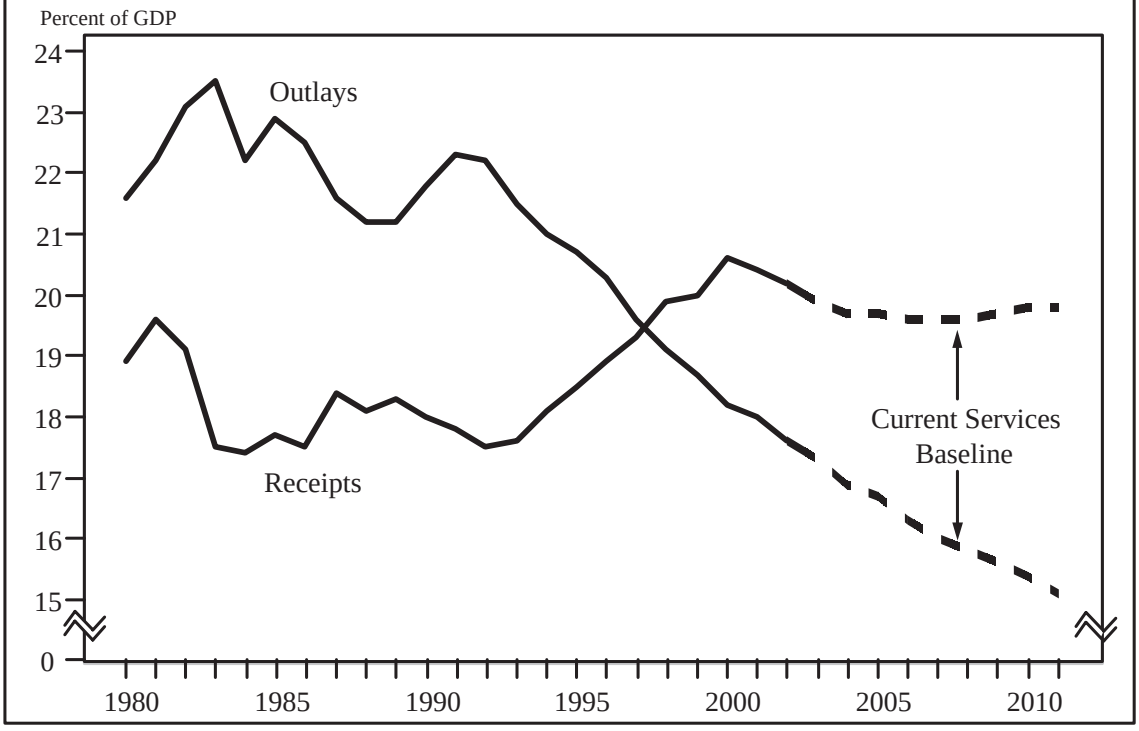
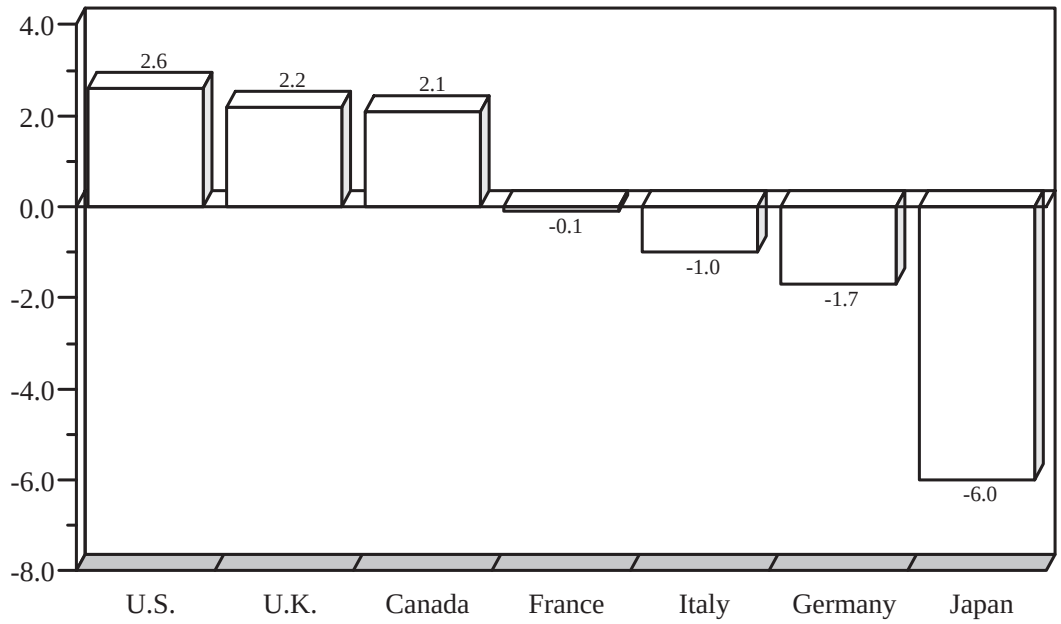


Chart II-5. Among the G-7 Countries the United States will have the Largest Budget Surplus in 2001

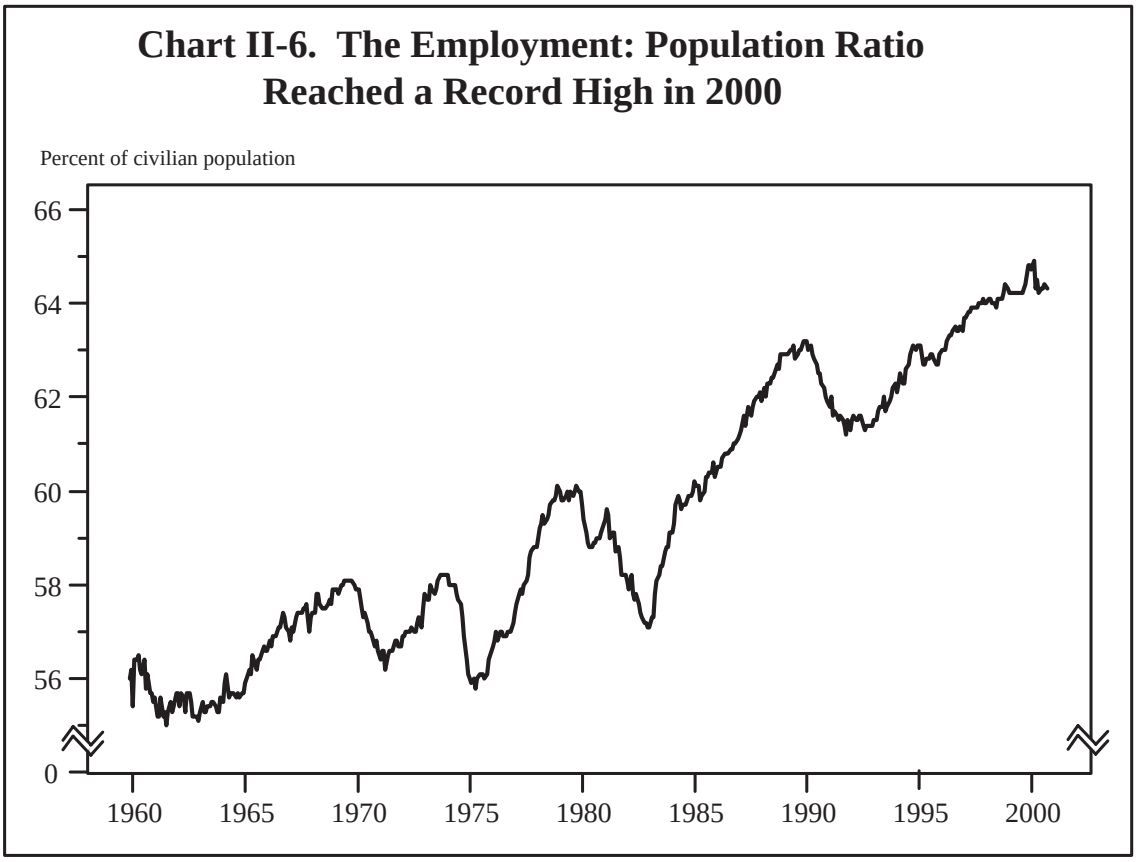


Source: Organization for Economic Cooperation and Development (OECD) Economic Outlook, December 2000

always been entrepreneurial and productive. However, the economy can grow faster and more consistently when budget policy, and monetary policy, are sound. Good budgetary policy is as important as monetary policy to such a successful outcome. And in fact, though the Federal Reserve has played a crucial role in this economic expansion, monetary policy was able to do its job better and more easily because of the sound fiscal policy of this Administration, as Fed members have acknowledged. Fiscal discipline, along with investment in our people and opening markets abroad—the other key elements of the Clinton economic strategy—has paid clear dividends in the economic performance of the 1990s.

Work Effort in the U.S. Economy Is at an All-Time High: Under the Clinton-Gore Administration, the share of the adult population that is employed has reached the highest point in U.S. history (see Chart II–6). The economic expansion, gaining strength as a result of greater confidence, lower interest rates, more investment, and accelerating productivity, created a veritable explosion of good job opportunities. Continuing investment in education at all levels improved the skills of new entrants into the labor force. Welfare reform and expansions of the Earned Income Tax Credit have increased labor force participation.

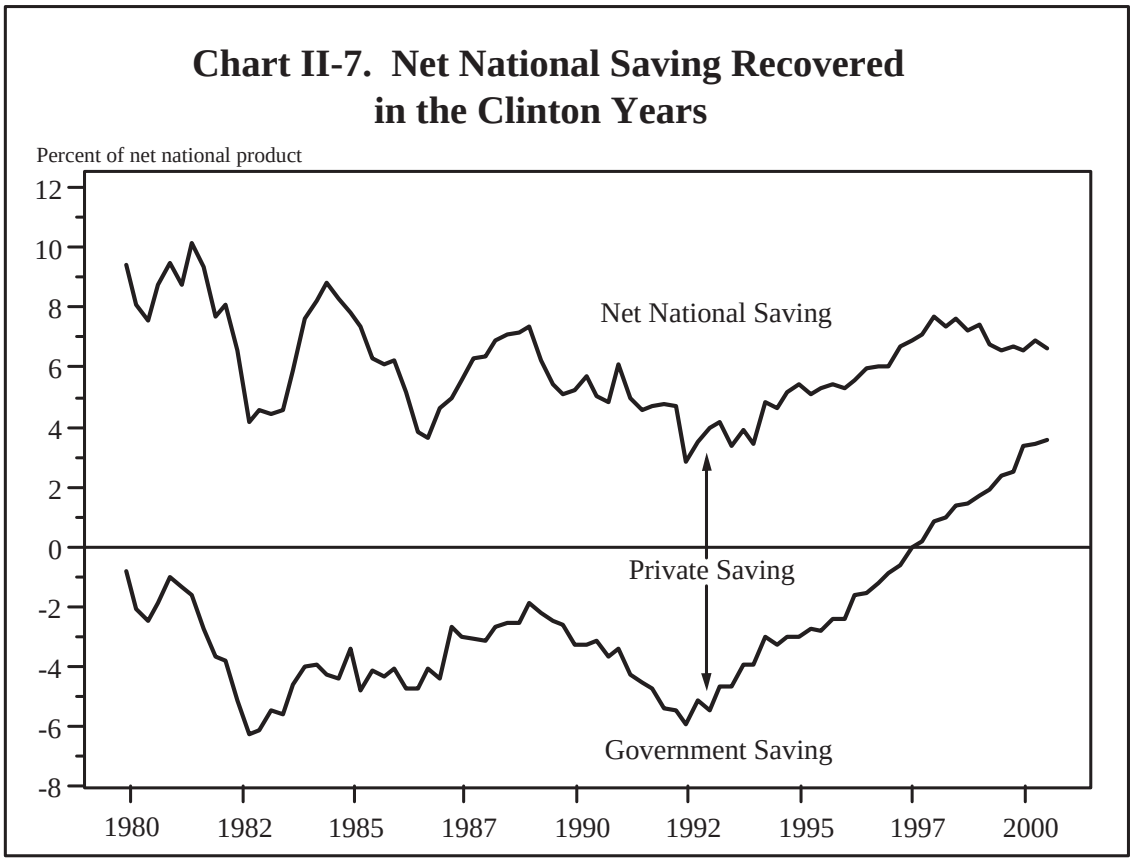
Between January 1993 and December 2000, the unemployment rate fell from 7.3 percent to 4.0 percent—the lowest it has been since the end of the 1960s. The economy created more than 22 million jobs, of which 92 percent were in the private sector, while Federal Government employment shrank. The net increase in jobs was larger under President Clinton than under the two previous Administrations combined. The healthy private labor market helped to make welfare reform a success by providing people leaving the welfare rolls with productive opportunities.



Real wages have risen under this Administration; the increase has been especially noticeable since 1995. Over the last five years, real hourly earnings have increased at an average annual rate of 1.3 percent per year. Over the preceding 20 years, hourly earnings had been falling at an average annual rate of 0.4 percent per year.

Administration Budget Policy Promoted National Saving: To get more capital, the economy needs more saving. For the economy as a whole, what matters is national saving—the sum of household saving, corporate retained earnings, and the Government surplus. Household saving is important, but it is only one component of national saving. A business that seeks to raise investment capital by floating a bond or selling a share of stock does not care, or even know, whether the funds come ultimately from households, other businesses, or government. National saving declined under the two preceding Administrations, but increased under President Clinton (see Chart II–7). This is a critical piece of evidence that the economic expansion of the 1990s is fundamentally different from that of the 1980s.

Furthermore, as is shown in Chart II–7, the entirety of the improvement in national saving came from the reduction of the Federal budget deficit. (The Federal Government's budget improved by more than the total increase in national saving; State and local governments as a group run roughly balanced budgets in every year, and hence did not contribute significantly to the budget improvement.) The overwhelming contribution of budget policy toward eliminating the 1998 budget deficit came from the Clinton-Gore Administration's initial budget plan. The BBA of 1997 and the economic growth generated by the Administration's fiscal discipline finished the job.

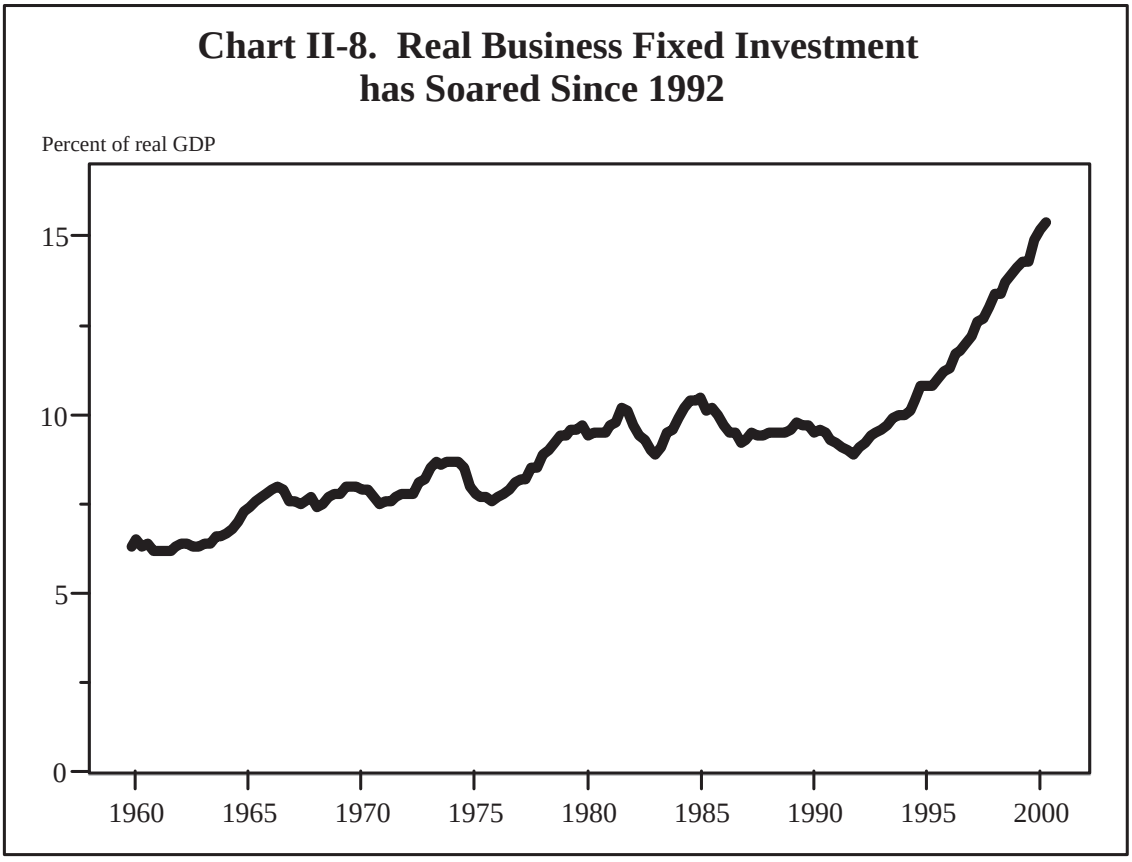


National saving went down in the 1980s, and up in the 1990s. National saving went up because Federal budget policy produced surpluses. And the Federal budget improvement began with the policy actions taken by the Administration in 1993.

Lower Interest Rates Enhanced Investment: The point of the Administration's policy of increasing national saving was to reduce Government's drain on investable funds, to bring down interest rates while increasing the funds available for private investment. This is a matter of supply and demand; with a larger supply of investable funds because of increased Government saving, the price of the funds—the interest rate—would be expected to go down. With the enactment of the President's program, interest rates fell; and even though unemployment has steadily declined since, interest rates have remained at or below the levels of the preceding recession.

With lower interest rates, businesses enjoyed a lower cost of capital for investment—a lower cost to take savings and convert it into capital for use in production. Given that national saving generally declined from 1980 to 1992, and increased from 1993 to the present, it might be expected that investment would be stronger under the current Administration than it was in the preceding 12 years; and again, that is what the record shows. The share of GDP devoted to business investment over the 1980s either declined slightly or was flat depending on the precise measure chosen. However, investment soared during the Clinton-Gore Administration (see Chart II–8).

The ratio of real business equipment investment to real GDP reached 12.4 percent in the third quarter of 2000. Since the beginning of 1993, inflation-adjusted investment in equipment and software has grown at an annual rate of 13.0 percent, more than 2¾ times the rate of 1981–1992. The

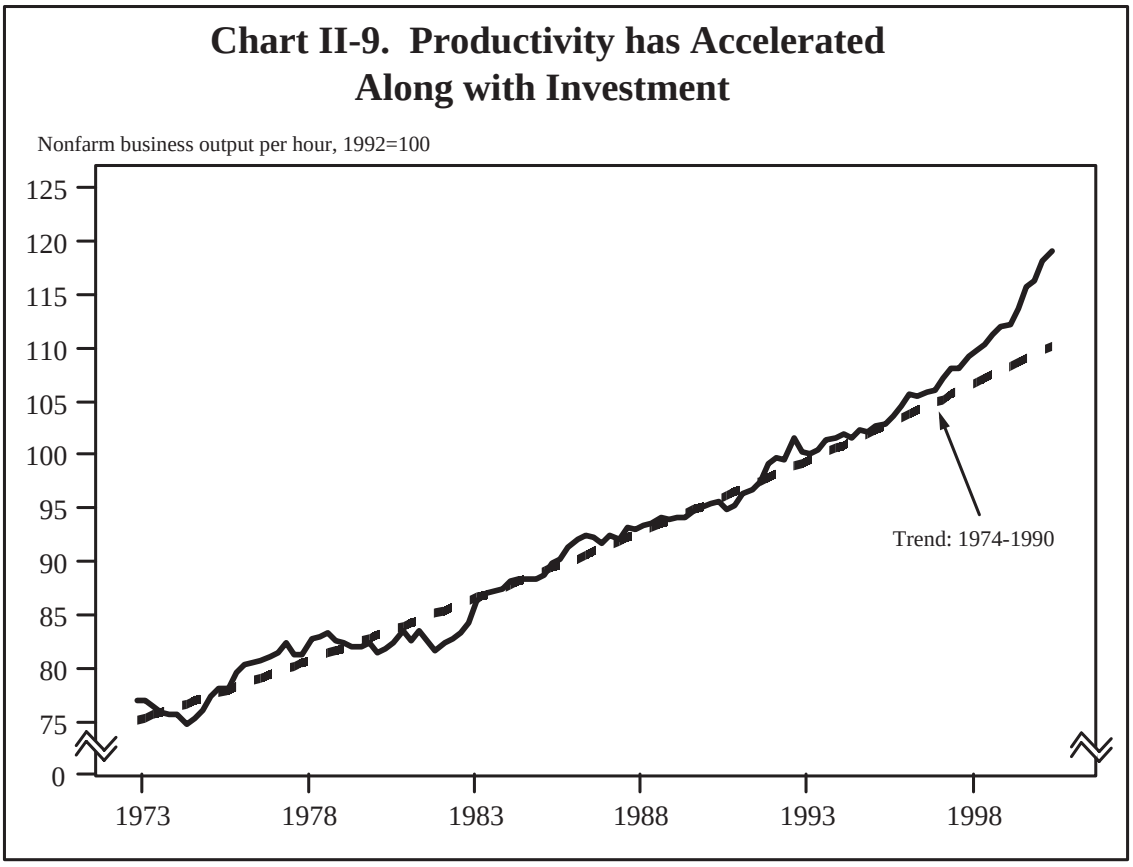


investment boom under President Clinton is the longest and strongest since World War II. The private sector has done the investing, but the Administration's policy of balanced budgets and fiscal responsibility clearly helped to bring interest rates down; and that helped to create the environment in which businesses could more confidently take business risks.

The Benefits of Faster Productivity Growth: Economists believe that strong investment pays a double dividend. First, it increases the size of the productive base of the economy; with more factories and machines, output can expand. But second, to the extent that new factories and machines are more efficient than the ones they replace, then productivity (the amount of output that we get from each hour of work) will rise. Under President Clinton, productivity growth has broken from the trend line that had prevailed since the early 1970s (see Chart II–9).

Enhanced productivity growth is important for many reasons; but perhaps most pertinent today, it makes an economic expansion more durable. Economic cycles usually end because inflation breaks out, which can occur when investment falls and productivity growth slows—as it did at the end of the 1970s, and the end of the 1980s. Continued strong investment has helped the current business expansion to continue for so long with low inflation. Productivity growth has increased, not declined, as this expansion has matured. Thanks to accelerated productivity growth due partly to increased capital intensity, the current expansion has lasted for almost 10 years; in February 2000, it became the longest expansion in U.S. history (the data go back to the mid-1800s), and each passing month sets a new record.

Increasing productivity is also important because it is the only route to sustained real-wage and living-standard growth. In the 1970s, U.S. productivity growth slowed

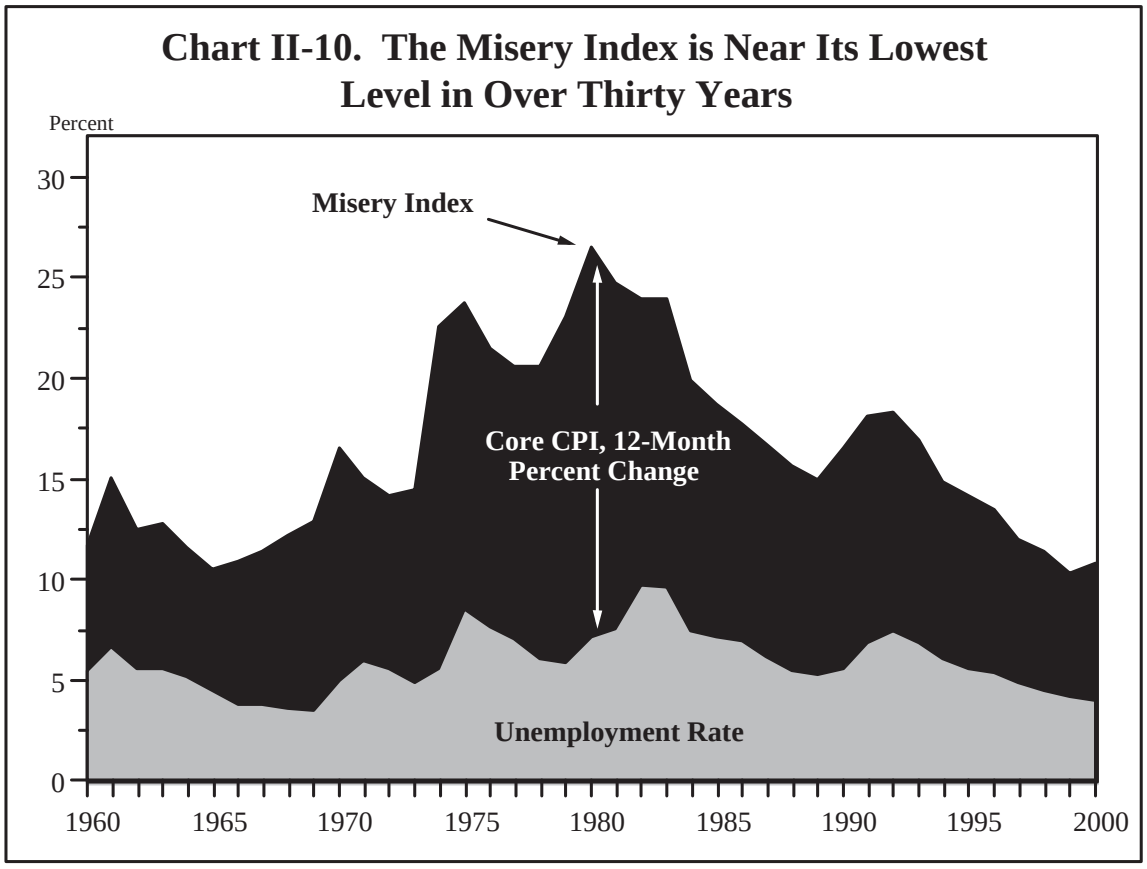


sharply. The average annual growth of output per hour in the nonfarm business sector fell from 2.8 percent (from 1949 through 1973) to 1.4 percent (from 1974 through 1990). When productivity grows at 2.8 percent per year, living standards double every quarter-century; but when productivity grows at only 1.4 percent per year, incomes grow by less than half. Over a generation, many workers can find themselves falling behind their parents, as well as their own expectations.

From the 1970s through the early 1990s, productivity growth stalled at the new slower rate. Since the mid-1990s, however, nonfarm business output per hour has grown at an average of 3.0 percent per year—slightly higher than the rate before the 1970s' slowdown (the break in the trend is shown in Chart II–9). Some of the speedup could be due to temporary factors; but the persistence of the higher growth rate for five years suggests that somewhat faster growth may be sustained. This is welcome news, not only for businesses seeking to hold down costs, but also for typical workers and their families, who once again see real improvements in their earnings.

The Misery Index Is Near a 30-Year Low: The success of budget and monetary policies shows also in the low unemployment and inflation under this Administration. The Misery Index—the sum of the annual unemployment rate and the core Consumer Price Index (CPI) inflation rate—was lower than at any time since the 1960s (see Chart II–10).

In 2000, the unemployment rate has averaged 4.0 percent—the lowest yearly average since 1969—while inflation has averaged just 2.7 percent (as measured by the core CPI, excluding volatile food and energy prices). The inflation rate crept up this year after its 34-year low in 1999, but remains near its average since 1995. This is the fifth year in a row of core inflation under three



percent—the best five-year record since the 1960s.

The turnaround in economic performance under President Clinton—faster economic growth, falling unemployment, and lower inflation—happened in the private sector; but it was aided by the Administration's budget policy and the Federal Reserve's monetary policy. The past eight years demonstrate that fiscal discipline and a matching monetary policy can generate more work, saving, and investment than an easy budget policy that ignores deficits and debt.

The Economic Outlook

The Clinton-Gore Administration has developed a final economic forecast, continuing its conservative, prudent approach (See Table II–1). No economic forecaster is accurate all the time, but the Administration believes that it makes more sense to plan for middle-of-the-road conditions, so that any budget errors are likely to be in the "right" direction, rather than to make long-term commitments for the best-case forecast, only to see spiraling uncontrolled deficits and debt. Previous Administrations more often overestimated economic performance; such mistakes are dangerous, because they can encourage policymakers to avoid hard and essential choices. One of the Administration's most important early decisions was to adopt a realistic economic forecast, and this philosophy has served the Nation well.

Table II–1. Economic Assumptions [1]

(Calendar years; dollar amounts in billions)

	Actual 1999	Projections											
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross Domestic Product (GDP):													
Levels, dollar amounts in billions:													
Current dollars	9,299	9,991	10,536	11,099	11,695	12,324	12,986	13,676	14,388	15,122	15,888	16,692	17,536
Real, chained (1996) dollars	8,876	9,337	9,645	9,954	10,272	10,601	10,941	11,284	11,627	11,968	12,315	12,672	13,039
Chained price index (1996 = 100), annual average	104.8	107.0	109.2	111.5	113.8	116.2	118.7	121.2	123.7	126.3	129.0	131.7	134.5
Percent change, fourth quarter over fourth quarter:													
Current dollars	6.5	6.7	5.3	5.4	5.4	5.4	5.4	5.3	5.2	5.1	5.1	5.1	5.1
Real, chained (1996) dollars	5.0	4.1	3.2	3.2	3.2	3.2	3.2	3.1	3.0	2.9	2.9	2.9	2.9
Chained price index (1996 = 100)	1.6	2.4	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Percent change, year over year:													
Current dollars	5.8	7.4	5.5	5.3	5.4	5.4	5.4	5.3	5.2	5.1	5.1	5.1	5.1
Real, chained (1996) dollars	4.2	5.2	3.3	3.2	3.2	3.2	3.2	3.1	3.0	2.9	2.9	2.9	2.9
Chained price index (1996 = 100)	1.5	2.2	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Incomes, billions of current dollars:													
Corporate profits before tax	823	934	922	934	961	990	1,035	1,080	1,127	1,162	1,196	1,226	1,251
Wages and salaries	4,470	4,767	5,031	5,310	5,608	5,917	6,233	6,566	6,904	7,264	7,637	8,028	8,437
Other taxable income [2]	2,141	2,286	2,353	2,422	2,488	2,561	2,649	2,745	2,843	2,943	3,048	3,152	3,263
Consumer Price Index (all urban): [3]													
Level (1982–84 = 100), annual average	166.7	172.3	176.8	181.4	186.2	191.2	196.4	201.7	207.2	212.7	218.5	224.4	230.4
Percent change, fourth quarter over fourth quarter	2.6	3.4	2.5	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Percent change, year over year	2.2	3.4	2.7	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Unemployment rate, civilian, percent:													
Fourth quarter level	4.1	4.0	4.3	4.6	4.7	4.8	4.9	5.0	5.1	5.1	5.1	5.1	5.1
Annual average	4.2	4.0	4.1	4.4	4.6	4.7	4.8	4.9	5.0	5.1	5.1	5.1	5.1
Federal pay increases, percent:													
Military and civilian [4]	3.6	4.8	3.7	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Interest rates, percent:													
91-day Treasury bills [5]	4.7	5.9	6.0	5.7	5.4	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
10-year Treasury notes	5.6	6.1	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8

[1] Based on information as of mid-November 2000.
[2] Rent, interest, dividend and proprietor's components of personal income.
[3] Seasonally adjusted CPI for all urban consumers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic adjustments to individual income tax brackets.
[4] Beginning with 2002, projected increases in the Employment Cost Index for private industry wages and salaries.
[5] Average rate (bank discount basis) on new issues within period.

The Near-Term Outlook

Real GDP Growth: Over the coming 10 years, the *Blue Chip* panel of 50 forecasters predicts a trend of real GDP growth averaging around 3.3 percent for most of the decade. The Administration's forecast for the next five years averages 3.2 percent. After 2005, the Administration projects growth slowing gradually to 2.9 percent per year in 2009–2011. Later this decade, the large baby-boom generation—born in the 20 years following World War II—will begin to retire. When that happens, labor force growth is likely to slow, pulling down real GDP growth. The initial effects of this demographic transition are reflected in the Administration's projections of real GDP for 2006–2011. It is not clear whether the private forecasters have begun to take account of this predictable shift in the labor force.

It is uncertain how much of the actual acceleration in productivity growth since 1995 will be sustained; but since last year's forecast, favorable evidence has mounted, and most economists are now more sanguine about prospects for productivity growth. Compared with the 2001 Budget assumptions, the Administration has increased projected potential GDP growth, and now projects that labor productivity in the nonfarm business sector can increase at an average rate of 2.2 percent per year through 2011.

Unemployment and Inflation: The unemployment rate in December was 4.0 percent, near the lowest point in three decades. It is projected to rise somewhat over the next few years, and to stabilize at an average rate of 5.1 percent—still well below the 6.7 percent average rate from 1970 through 1992.

Inflation was boosted this year by a spike in oil prices; but oil futures market prices imply relief in 2001, and so inflation is likely to decline. The Administration projects CPI inflation of 2.5 percent in 2001 (on a fourth quarter to fourth quarter basis), following a 3.4 percent rate during 2000. CPI inflation is expected to average 2.7 percent per year for 2002 through 2011—close to the average of 2.5 over the past five years. Inflation in the GDP chain-weighted price index is projected to average 2.1 percent through 2011. These projections maintain the gap that has emerged in recent years between these two measures of inflation.

For several years, real GDP has grown faster than mainstream forecasters believed would be sustainable without higher inflation. This year's moderate upward revision to the estimate of potential GDP growth is consistent with this performance; strong investment in new technologies is paying off in higher productivity. However, some of the rapid GDP growth of the last eight years came because labor force participation was increasing and unemployment was falling. Looking ahead, the unemployment rate is likely to rise slightly and labor growth is projected to slow, which the Administration believes will moderate the pace of GDP growth.

Interest Rates: Interest rates on Treasury debt fell to extremely low levels—short maturities under five percent—during the world financial crisis of 1997–1998. Since then, short-term rates—following several interest rate hikes by the Federal Reserve during 1999 and 2000—have risen to their highest level since 1991; the 91-Day Treasury Bill discount rate was 5.7 percent in late December. The yield on 10-year Treasury notes also rose in 1999, but it retreated in 2000; in late December, it was about ½ percentage point below the short-term rate. The Administration projects that the 10-year rate will average near 5.8 percent—its level of mid-November—throughout the forecast period. Meanwhile, the short-term rate is projected to decline gradually to around 5.3 percent, which would restore the usual upward-sloping yield curve. The outlook is complicated by the ongoing reduction in Federal debt, which gradually removes Government bills, notes, and bonds from the market.

Trend Projections: Except in the near term, the projections shown in Table II–1 are not a precise year-to-year forecast; instead, they reflect the average behavior expected for the economy over the medium term. In some years, growth could be faster than assumed; in other years, it could be slower. Similarly, inflation, unemployment, and interest rates could fluctuate around the projected values. If the assumptions hold on average, however, they should provide a prudent basis for budgeting. If fiscal and monetary policies remain sound, the economy could continue to

outperform these relatively conservative projections, as it has for the past several years.

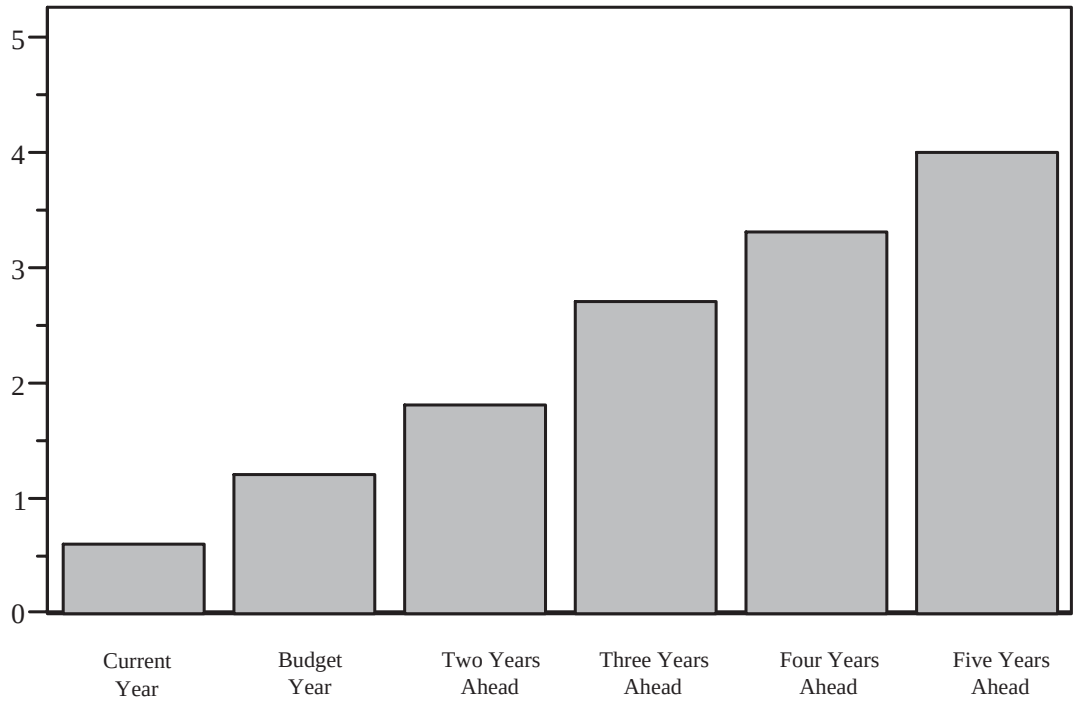
The Budget Outlook

The Near-Term Outlook: The Administration projects continuing budget surpluses in 2001 and subsequent years. On current-services assumptions, the unified surplus is projected at $256 billion in 2001 and $277 billion in 2002. The on-budget surplus, $86 billion in 2000, is projected to be $98 billion in 2001. By 2011, it could reach $479 billion.

These projections are imprecise, and if experience is any guide, they could err by large margins. The future is uncertain, and the more distant the projection, the greater the uncertainty. Over the history of five-year budget projections (first required by the Congressional Budget Act of 1974, and thus starting with the 1976 Budget), every Administration has made substantial errors. Chart II–11 shows that the average forecast error for the deficit/surplus (regardless of sign, expressed as a percentage of GDP) of the fiscal year already in progress was 0.6 percent of GDP (in today's terms, over $60 billion—not a trivial sum for a year already one-fourth over). The average error for the coming year was twice as large—1.2 percent (or more than $120 billion today). Errors grew even larger as the projection was more distant, averaging 4.0 percent of GDP (more than $400 billion today) for the five-year ahead (the most distant) projections. (The Clinton-Gore Administration's errors were only slightly smaller than those of other Administrations, though unlike all the others, we have run smaller deficits and larger surpluses than we projected.) Such enormous uncertainty about budgets just a few years in the future should influence policymakers' decisions about expensive, long-term commitments on the basis of mere projections—especially now, when the public debt, though declining, is still about the same percentage of GDP as in 1985; and

Chart II-11. Long-Term Budget Projections Require Caution

(Average absolute surplus/deficit projection error as a percent of GDP, 1976-2001)



when the baby-boom generation is just seven years away from beginning to collect Social Security benefits.

The Long-Term Outlook: Though long-run budget projections are inherently uncertain, they can warn of potential problems, which may be more easily solved if addressed sooner. In the 1990s, policymakers increasingly focused on long-range projections, some looking as far as 75 years ahead—especially for the budget effects of population aging and reforms to Social Security or Medicare.

Prior to the 1993 Clinton program, the Federal deficit was projected to spiral out of control in this decade. The outlook improved after OBRA, although deficits continued for a time. Following the passage of the BBA in 1997, a unified budget surplus was projected beginning in 2002, and for about 20 years; even so, the deficit was expected to return in the long run.

Since 1997, the economy and the budget have performed much better than projected when the BBA was passed. Projections of publicly held Federal debt have steadily declined. Lower interest payments have reinforced the improvement of the budget, and have significantly extended the long-run surplus projections. Still, the long-term current services baseline is a mechanical extrapolation of the budget implications of current law, and thus is not intended to reflect likely policy actions. Moreover, the range of uncertainty around such projections is very large. Under reasonable alternative assumptions, the budget could return to deficit within a few years following the retirement of the baby-boomers. The underlying demographic pressures are formidable, and if the demographic or economic outcomes prove to be less favorable than assumed here, the surplus would be threatened. (See *Budget of the United States Government, Fiscal Year 2001: Analytical Perspectives,* chapter 2; and *Economic Report of the President,* January 2001, chapter 2.)

The favorable long-term budget results in these projections can be realized only with prudent policy—choosing continuing reductions in outstanding debt, rather than expensive tax cuts or spending increases—while sustaining private saving, investment, and productivity growth.