

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

An Overview of the Clinton Budget Plan

by David Altig and Jagadeesh Gokhale

Virtually all government policies alter the allocation of economic resources. The timing of the policies, the nature of government spending, and the form of revenue collection affect decision-making over time, change the distribution of costs and benefits across households and firms, and reshuffle the burdens borne by different generations. Whether intended or not, allocative consequences are the reality of economic policy.

The far-reaching changes in spending and tax priorities represented by the Clinton administration's stimulus package and first budget proposal are no exception. In this *Economic Commentary*, we present an overview of the Clinton plan that emphasizes the timing of spending and revenue changes, the fiscal mix that the plan would deliver, and the generational impact of the proposals as a whole. We neither endorse nor condemn the plan or any of its components; nor do we survey empirical or theoretical arguments for one position or another. Our goal is to present the material in a way that will help readers come to their own conclusions about the desirability of the budget proposal on its own terms.

Our focal point is the plan detailed in the document *A Vision of Change for America* (henceforth referred to as *Vision*), issued by the Office of Management and Budget (OMB) on February 17, 1993, and in *Budget of the United States Government, Fiscal Year 1994*, issued April 8, 1993.¹ Although revisions have already been proposed in both the Senate and House of Representatives, it is useful to concentrate on

the original administration proposals for two reasons. First, the basics of the plan have remained intact, at least through the early stages of the budget process. Second, the administration's budget proposals provide a relevant benchmark by which all amendments and alternatives can be judged.

In our presentation we rely, as much as possible, on calculations provided by the Congressional Budget Office (CBO). The numbers presented by the administration differ somewhat from the CBO figures, due largely to technical corrections and to differences in the baseline from which deficit changes are calculated. We briefly describe these adjustments in the next section, presenting the bottom-line deficit reduction implied by the Clinton plan of \$355 billion over the period from fiscal year (FY) 1993 through FY1998.²

The remaining sections of this article present the timing and composition of net outlay cuts, the timing and composition of net revenue increases, and the generational impact of each. We show that 1) the majority of deficit cuts, in dollar terms, are deferred to the later years of the plan, with 70 percent of the total being realized in FY1997 and FY1998; 2) through FY1995, revenue increases actually exceed deficit cuts, and cumulatively account for 75 percent of the total dollar reduction in deficits over the entire six-year horizon; 3) the plan would shift resources, via both expenditure and tax policy, toward nondefense discretionary spending; and 4) the proposals would reduce the

Instead of concentrating narrowly on the level of deficit reduction in the proposed federal budget, a more comprehensive picture can be gleaned from investigating the allocative consequences of shifts in resources that will result if the Clinton plan is adopted. Here, the authors examine the timing and composition of both net outlay cuts and net revenue increases, and the generational impact of each, to assess the likely effects of the sweeping changes in spending and tax priorities represented in the administration's stimulus package and first budget proposal.

net payment burden on future generations implied by existing fiscal policies.

■ The Bottom Line

Change requires a status quo. In *Vision*, the status quo is defined as the outlay and revenue paths that would be realized given the enacted FY1993 budget, adjusted for cuts in defense spending proposed by the Bush administration. The difference between these revenue and outlay paths gives the baseline deficit path. According to the Clinton administration calculations, the level of outstanding debt at the end of FY1998 would be roughly \$440 billion less under its plan than if the status quo fiscal policies were maintained.³

However, subsequent estimates by the CBO suggest that this number is overstated for two reasons.⁴ First, the estimates differ due to alternative technical

assumptions, such as the amount of revenue that will be collected from increasing marginal tax rates. Second, the Clinton administration failed to include spending cuts mandated by the Budget Enforcement Act of 1990 (BEA) in its estimates of baseline outlays. Because these cuts are required under current law, the outlay reductions necessary to meet BEA spending limits should not be counted as spending changes brought about by the Clinton plan.⁵

Box 1 summarizes the effects of the CBO reestimates of the Clinton deficit reductions. According to CBO calculations, by the end of FY1998 the Clinton plan would actually result in \$355 billion less debt than the status quo fiscal policy, holding all else fixed. Throughout the balance of this presentation, we will use the CBO projections unless otherwise indicated.⁶

■ A Brief Word on the Definition of Spending

Some confusion has been generated by terminology used in the administration's budget presentation. For example, taxes on Social Security benefits are sometimes identified as spending cuts, and investment tax credits as spending increases. Although these rhetorical choices can be supported by reasonable economic arguments, they do not conform to standard budgetary classifications, which would treat the former as a positive revenue item and the latter as a negative one.

We identify revenues and outlays according to their conventional definitions, which are those that would be legally controlling in the budget process.⁷ Our choice in this regard is motivated by our desire for clarity, and we make it without passing judgment on the administration's semantics.

■ The Timing of Revenue Increases and Deficit Reduction

Figure 1 illustrates the year-by-year amounts of deficit reduction and revenue increases implied by the Clinton plan. The reductions amount to less than \$20 billion in FY1994, but rise to \$117 billion in FY1997 and \$131 billion in

BOX 1 CBO ADJUSTMENTS TO THE CLINTON DEFICIT REDUCTION ESTIMATES

| | | |
|--|--------|------------------------|
| Accumulated Deficits, FY1993-98: Baseline | | \$1,949 billion |
| | less | |
| Accumulated Deficits, FY1993-98: Clinton Plan | | <u>\$1,509 billion</u> |
| | equals | |
| Administration Deficit Reduction Estimates | | \$ 440 billion |
| | less | |
| CBO Adjustments | | <u>\$ 85 billion</u> |
| | equals | |
| CBO Estimates of Clinton Plan Deficit Reductions | | <u>\$ 355 billion</u> |

FY1998. In general, the bulk of the deficit cuts is deferred to later years: Including a \$7 billion increase in FY 1993, the Clinton proposal would shrink the deficit by less than \$40 billion through FY1995. A full 70 percent of the promised curtailment is to be realized in FY1997-98.⁸

Like deficit reductions, revenue increases rise in dollar value as the plan is implemented over time. However, in FY1994 and FY1995, revenue increases exceed the amount by which the deficit is pared down. This, of course, means that revenues in these years finance the entire amount of deficit reduction and actually support net gains in outlays. Not until FY1996 does the deficit contraction exceed the amount of extra revenue that the Clinton plan would deliver, and even then revenues account for more than 80 percent of that year's reduction.

Through FY1998, the Clinton plan would generate \$267 billion of revenue beyond the amount that would be collected under current policy. This figure would represent 75 percent of the total deficit reduction if the plan is implemented as presented. In other words, 75 cents of every dollar of deficit reduction is slated to come from revenue increases.⁹

■ A Closer Look at the Revenue Side

Figure 2 illustrates the year-by-year and cumulative distribution of all items in the Clinton plan that increase federal revenues.¹⁰ The largest single category is associated with higher taxation of "high-income" individuals. These revenues

would be generated by increasing the top marginal tax rate to 36 percent, adding a surcharge on taxable incomes in excess of \$250,000, eliminating the limit on the amount of wage income subject to the Medicare payroll tax, and increasing estate taxes. Revenues from these sources would account for about 64 percent of gross revenue increases in FY1994 and for about 44 percent cumulatively.

The proposed energy tax is the next-largest revenue item, accounting for 23 percent of gross revenue increases through FY1998, although much less in the plan's first two full years. Business taxes account for about 16 percent of the hike, primarily due to a rise in the corporate tax rate and to new restrictions on deductions for business meal and entertainment expenses. Increased taxation of Social Security benefits, which has generated much public discussion, would in fact account for a relatively small amount of the total revenue increase, between 6 and 7 percent.

The extra revenue from all of these changes actually sums to more than the \$267 billion in net increases shown in figure 1. That is, the amount collected by these taxes will exceed \$267 billion because the administration plan includes a variety of tax credits and subsidies, which together would amount to about 21 percent of the gross revenues that the proposal would generate through FY1998. The distribution of these tax incentives is illustrated in figure 3. Approximately 70 percent of the total is

divided equally between earned-income tax credits for the working poor and investment tax credits for firms. Most of the balance consists of sundry tax breaks for various activities labeled "infrastructure" by the administration, which include tax credits for low-income housing construction, research and experimentation expenditures, and enterprise-zone investments.

■ **A Closer Look at the Outlay Side**

The Clinton plan would significantly shift federal spending priorities. Figure 4 illustrates the change that would result in four distinct outlay categories: defense, nondefense discretionary, mandatory, and net interest.¹¹ Discretionary spending involves all forms of outlays, including defense, that are subject to the usual appropriations process. Mandatory expenditures include the major entitlement programs such as Social Security and Medicare.

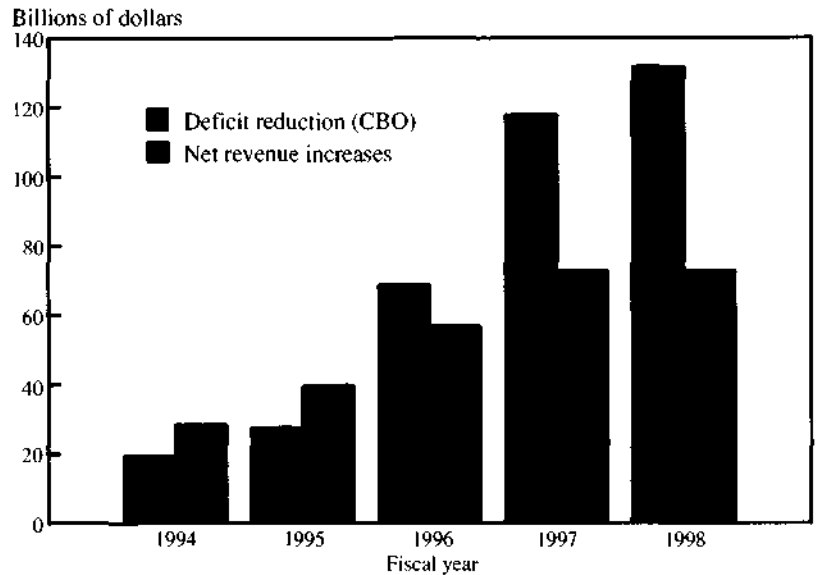
Defense, mandatory, and net interest outlays would all ultimately decline relative to their baseline paths if the Clinton plan is realized. However, nondefense discretionary spending would actually be higher in each of the years from FY1993 through FY1998. This comes as no surprise, since most of the spending programs that candidate Clinton advocated — highway construction funds, job training programs, directed technology expenditures, expanded Head Start funding — fall into this category.

Over the entire 1993–98 period, defense outlays would be reduced by about \$112 billion and other discretionary outlays would rise by about \$107 billion, leaving total discretionary outlays virtually the same as under the status quo policy. Thus, most of the net outlay reductions in the Clinton plan come from the mandatory and net interest categories. The former are primarily associated with projected Medicare savings and the latter with lower deficits.¹²

■ **Putting the Outlay and Revenue Changes in a Generational Context**

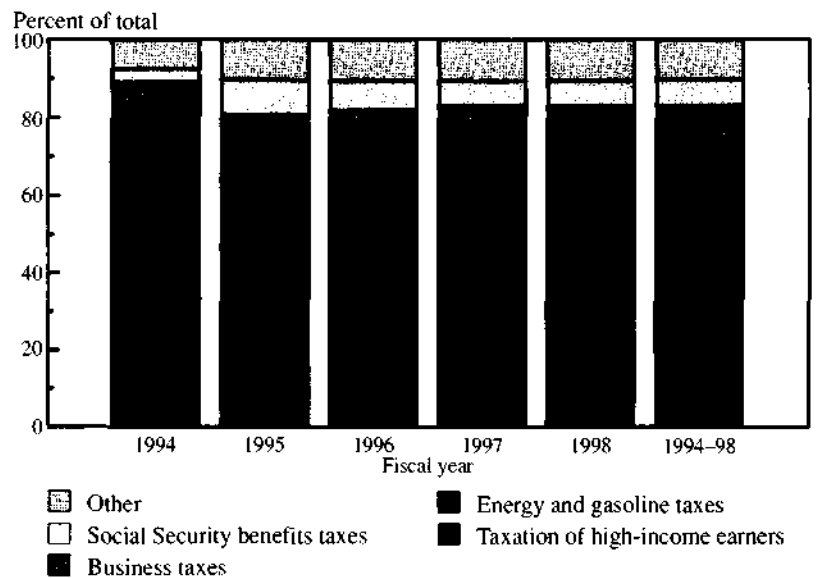
Implicit in the figures discussed to this point is a change in the generational burden of federal tax and expenditure programs. A gauge of the proposals' direct

FIGURE 1 REVENUE INCREASES AND DEFICIT REDUCTION IN THE CLINTON PLAN



SOURCE: Congressional Budget Office.

FIGURE 2 DISTRIBUTION OF REVENUE INCREASES BY TYPE IN THE CLINTON PLAN



SOURCE: Office of Management and Budget.

impact in redistributing resources among living and future generations can be obtained by performing calculations that yield a set of generational accounts.

Generational accounting is based on the government's intertemporal budget constraint, which states that the present value of government spending must be paid out of the government's net wealth, resources taken from existing generations, and resources taken from

future generations. Given no change in either the government's net wealth or spending policy, policies that increase the amount taken from living generations imply that future generations will have to pay less. Alternatively, an enactment of spending cuts with no change in the net payment burdens of living generations will also translate into lower burdens on future generations.

A generational account is the present value of taxes net of government trans-

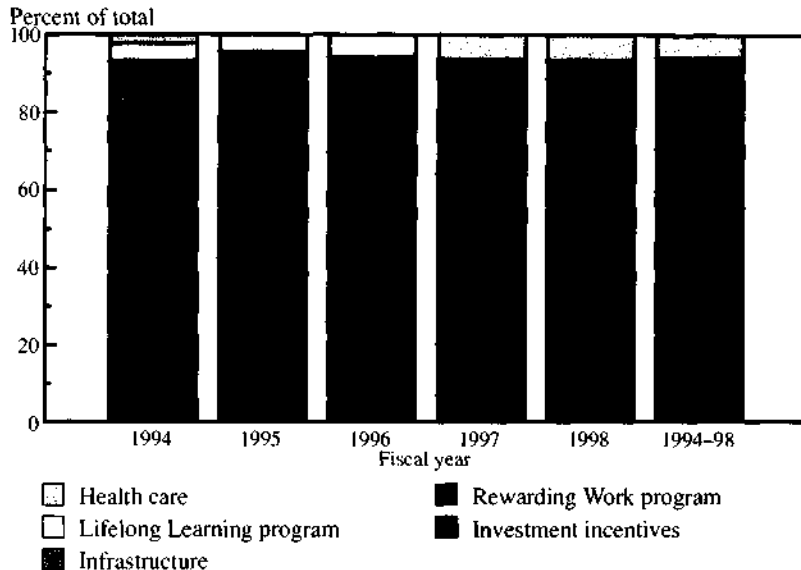
fers that each member of a given generation may expect to pay over his or her remaining lifetime.¹³ For each generation, the difference between its generational account computed under baseline projections and that computed under the Clinton proposals indicates the impact of the plan on its net payment burdens.¹⁴ Suppose, for example, that under the Clinton plan an average male born in 1956 would receive an extra \$1,000 in unemployment benefits, tax credits, and so on, but would pay an extra \$6,000 in assorted federal taxes (all in present-value terms). Then the change in the net payment burden for a man age 35 in 1991 would be \$5,000.

Figures 5 and 6 show net payment burdens for living and future generations both before and after adoption of the Clinton plan. The figures reveal that under today's policies, older generations can expect to receive, and middle-aged and younger generations can expect to pay, on net, to the government over their remaining lifetimes. Current policies also embody a sizable imbalance in that future generations will be required to pay, on average, more than twice as much per capita as will current newborns if the latter are treated as they would be under baseline policies over their lifetimes.

President Clinton's budget proposals imply a relatively minor increase in the payment burdens of all living generations. Moreover, the changes are distributed fairly uniformly across age and sex groups.¹⁵ Among men, the increases are largest for young and middle-aged generations (those aged 20 to 45 in 1991), mostly because of higher labor income taxation. Among women, however, the largest rise in payment burdens is for generations aged 55 to 70 (in 1991), due primarily to reduced health and Social Security benefits.¹⁶ By requiring living generations to pay more and by lowering government spending on purchases, the Clinton proposals reduce the per capita payment burdens on future males by about \$30,000 and those on future females by about \$14,000.

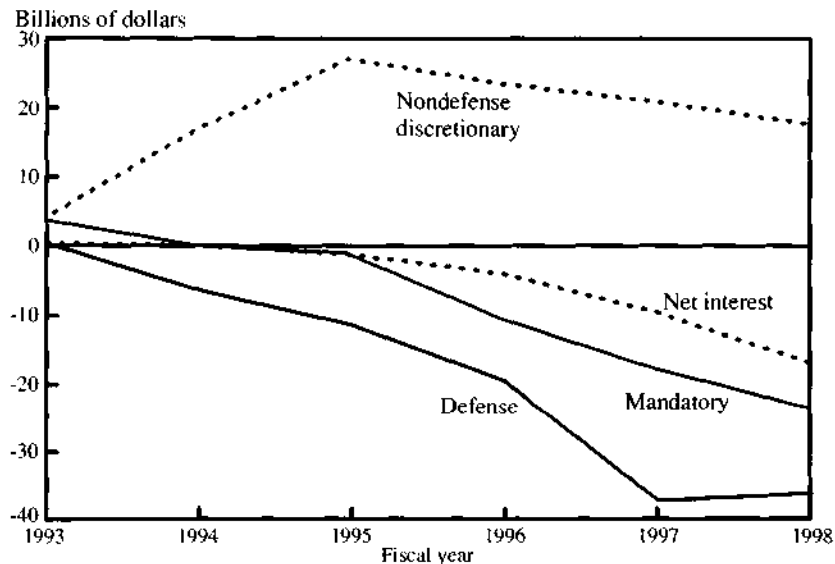
Generational accounting does not reveal the set of spending, tax, and trans-

FIGURE 3 DISTRIBUTION OF TAX INCENTIVES BY TYPE IN THE CLINTON PLAN



SOURCE: Office of Management and Budget.

FIGURE 4 OUTLAY CHANGES IN THE CLINTON PLAN



SOURCES: Congressional Budget Office; and Office of Management and Budget.

fer changes that would best redress the imbalance in current fiscal policy. It is useful only for evaluating the impact of a given set of policy changes on intergenerational redistribution. While they fall far short of eliminating the imbalance in current fiscal policy, the Clinton proposals are, on this count, a step in the right direction.

Concluding Remarks

On balance, the allocative aspects of the Clinton plan are more striking than the amount of deficit reduction that it would deliver. Using CBO estimates

and economic assumptions, the federal deficit under the administration plan would equal about 3 percent of GDP in FY1998, or about the same percentage that was realized in FY1989 under the final budget of the Reagan administration, and the last one prior to the prolonged period of sluggish economic growth that commenced in 1990.

This comparison indicates why judging fiscal policy by the level of the deficit can be highly misleading. Although the deficits implied by the Clinton administration's proposals would basically re-

turn us to the deficit-to-GDP ratios that characterized the latter part of the 1980s, the plan does indeed represent a major shift in the fiscal policy mix. Furthermore, the recent budget resolutions passed by the House and Senate do little to alter these changing priorities.¹⁷ Thus, in all probability, the plan's success or failure will ultimately be judged not on the dollar amount of resulting deficits, but on whether the shifts in resources identified in this article deliver the economic prosperity that the administration has promised.

■ **Footnotes**

1. Some technical and program adjustments were made in the April budget document, but these were minor. Thus, the essence of the Clinton plan is well represented by information contained in *Vision*.

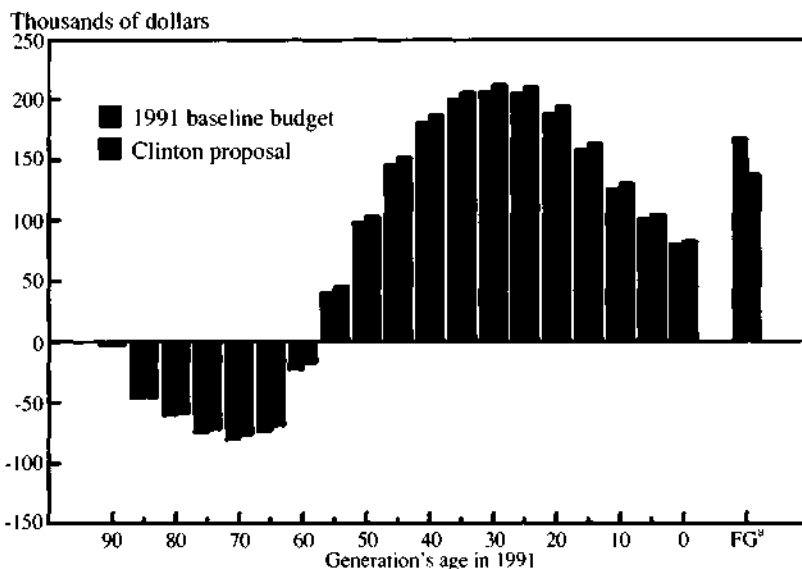
2. Although the FY1993 budget was developed and passed during the Bush administration, the Clinton proposals do contemplate changes in outlays and deficits that would become effective in the current fiscal year. Accordingly, we include FY1993 budget changes in our analysis.

3. The OMB figures assume the same macroeconomic outcomes when calculating both baseline deficits and projected deficits under the Clinton plan. These estimates were provided by the CBO. To summarize briefly, the projections assume that real GDP will grow by 2.8 percent in 1993 and then decline toward the assumed long-run growth rate of 2 percent after increasing slightly in 1994. The unemployment rate is projected to fall steadily from 7.1 percent in 1993 to 5.7 percent in 1998. The CPI inflation rate and the 10-year Treasury note rate are expected to remain fairly stable, averaging 2.7 percent and 5.5 percent, respectively. Short-term interest rates, measured by the average return on 91-day Treasury bills, are projected to increase from 3.2 percent in 1993 to 4.9 percent in 1998.

We note that the administration does expect more robust economic activity if its policy proposals are implemented. However, its architects have chosen to avoid "rosy scenario" accusations by applying the conservative CBO assumptions to their own deficit projections.

4. Information on CBO adjustments to the administration projections are taken from preliminary estimates as of March 23, 1993. The CBO estimates do not include changes made between the publication of *Vision* and that of the formal FY1994 budget proposal, such as revisions in the proposed energy tax.

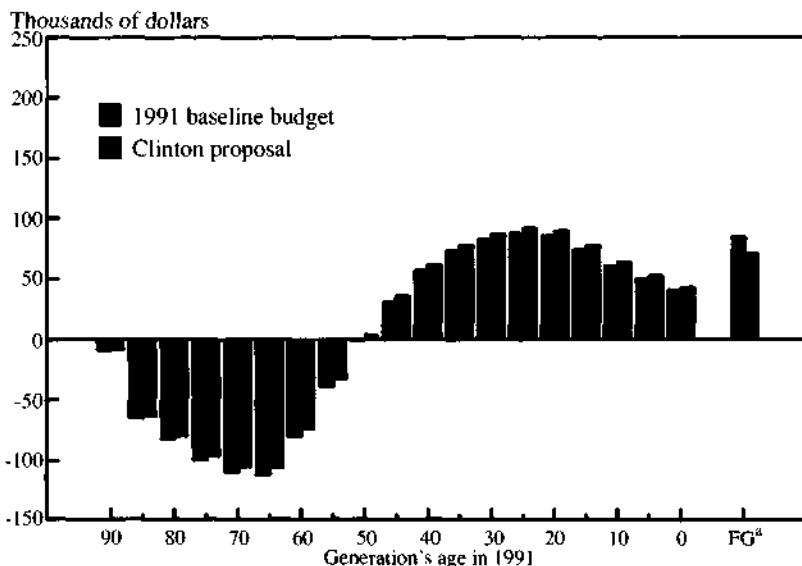
FIGURE 5 NET PAYMENT BURDEN ON MALES IN THE 1991 BASELINE BUDGET AND CLINTON PLAN



a. Future generations.

SOURCES: Office of Management and Budget; and authors' calculations.

FIGURE 6 NET PAYMENT BURDEN ON FEMALES IN THE 1991 BASELINE BUDGET AND CLINTON PLAN



a. Future generations.

SOURCES: Office of Management and Budget; and authors' calculations.

5. For an overview of BEA, see David Altig, "Some Fiscal Advice for the New Government: Don't Let the Sun Go Down on BEA," Federal Reserve Bank of Cleveland, *Economic Commentary*, February 1, 1993.

6. President Clinton expressed general confidence in CBO projections in his State of the Union address, given the same day that *Vision* was released. Also, additional spending cuts recently proposed by the House and Senate budget committees were at least partially designed to adjust for the shortfalls identified by the CBO.

7. For example, infrastructure investment would typically fall under the category of "discretionary" outlays, which are limited by BEA. However, spending that is generated by investment tax credits would show up in net revenues and hence would not be subject to BEA limits.

8. Aware that postponing the bulk of the proposed deficit cuts to later years raises the issue of credibility, the administration has proposed that spending limits similar to those legislated by BEA in 1990 coincide with passage of the budget. The current BEA limits are applicable through FY1995. Adjustments to the administration's proposals that were passed out of the House and Senate budget committees in the week ending March 12 were apparently made in part to ensure that existing BEA spending restrictions are honored.

9. This number rises to 83 cents if outlay reductions associated with lower net interest payments are excluded from the spending cuts. The administration estimates that under its plan, total net revenues and receipts will rise by about \$293 billion over the FY 1993-98 period.

10. CBO updates on specific revenue items were not available as of this writing. The distributions presented in this section are based on numbers reported in *Vision* and in the FY1994 budget document.

11. The totals for discretionary, mandatory, and net interest outlays are all taken from the March CBO estimates. We divide total discretionary outlays into defense and nondefense components using the administration proposals presented in *Vision*. In so doing, we implicitly assume that all of the discretionary spending cuts required to meet BEA limits in FY 1994 and FY 1995 come from nondefense programs.

12. The administration estimates of net interest reductions include projected savings from changing the maturity structure of the outstanding stock of debt. These cost reductions are not included in the CBO estimates, which are the basis for the numbers we present.

13. A generation is defined as all members of a given age and sex. More detailed explanations of the generational accounting concepts can be found in Chapter 26 of *Budget of the United States Government, Fiscal Year 1993*. See also Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A New Approach to Fiscal Policy Evaluation," Federal Reserve Bank of Cleveland, *Economic Commentary*, November 15, 1991.

14. For purposes of calculating the generational accounts, the baseline projections are taken from the OMB's *Mid-Session Review of the Fiscal Year 1993 Budget*, July 1992. Evaluation of the Clinton proposals is based entirely on data reported in *Vision*.

15. As a result of the proposals, older generations may expect a reduction in receipts over their remaining lifetimes.

16. While the health care measures announced thus far mainly affect the incomes of health care providers, the generational accounting exercise assumes that these will be passed along in the form of reduced benefits. Also, increased Social Security taxation amounts to a reduction in net benefits.

17. Because of resistance in the Senate, the fate of the stimulus part of the Clinton plan, which includes about \$17.8 billion of spending and \$6.4 billion of tax incentives, was still in doubt as of this writing.

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