Five years of strong economic growth have transformed the federal budget: Perennial deficits have given way to growing annual surpluses. January 1997 projections by the Congressional Budget Office showed a $171 billion deficit for FY2000. The most recent projections (assuming that discretionary spending grows with inflation) indicate a $232 billion surplus for the same year—a $403 billion difference. A stronger economy and unanticipated budgetary outcomes contributed $440 billion to this improvement, while policy changes subtracted $37 billion.

Most revisions to the budget picture result from accelerating revenue growth, not decelerating government outlays. Overall, taxable income—wages and salaries plus enterprises’ book profits—grew faster than GDP, raising the effective tax rate on income. The fastest income growth occurred in the highest brackets, further increasing the effective income tax rate, and stock price surges swelled the revenue from capital gains taxes.

Outlays in FY2000 are currently expected to be $101 billion less than the January 1997 projection. Lower-than-expected inflation reduced mandatory outlays that are indexed to inflation. Medicare payouts fell in the last three years, fueling hopes for moderate growth in future spending. Finally, compared to the 1997 projections, accumulating surpluses since 1998 have reduced debt held by the public, lowering interest costs.

But this bright budget outlook is uncertain. Downside risks include near- or medium-term decay in productivity and income growth, higher health care outlays, and inability to contain discretionary spending growth at or below the inflation rate.