PERSPECTIVE BUDGET SURPLUS

Lee Hoskins
Shadow Open Market Committee
March 1998

For the first time in three decades the federal budget may generate a surplus. While no surplus is yet in hand, plans are being made to spend it. President Clinton in his State of the Union address linked projected federal budget surpluses to saving Social Security. His statement is misleading and diverts attention away from the real problem—low national saving. To begin with, there is no surplus when future promised benefits are taken into account. The present value of all expected federal outlays is far greater than the present value of all expected federal revenues, under current law and with reasonable economic and demographic assumptions. Even the budget surpluses now projected for the next decade would be insufficient to directly make up the difference. The answer to the saving shortfall is swift implementation of policies that enhance saving and investment. Good economic policy, not more meddling financed by surpluses, will improve our chances at higher living standards for the future.

One Man's Surplus is Another Man's Poison

The Administration's budget has a $9.5 billion surplus in fiscal 199, providing a huge tobacco tax increase becomes law. The Congressional Budget Office (CBO) projections, based on current policies, have a surplus of $14 billion starting in fiscal year 2001 and rising to $138 billion by 2008.[1] (The CBO recently revised these figures to show a surplus starting in fiscal 1998.) The CBO has real growth in the range of 2.0 to 2.3 percent during this period and inflation (CPI) at 2.8 percent. Outlays fall from 20.1 percent of GDP in 1997 to 18.3 percent in 2008, substantially below the norm for the past 30 years. Revenues decline from 19.8 percent of GDP to 19.3 percent during the same period, still high by historical standards.

The performance of the economy obviously is a big uncertainty with these projections. A moderate 1990 type recession could swing the budget into a major deficit for a year or so. Even a moderation in the bull market for equities could send the budget into deficit again. Much of the flood of revenues in the past two years is attributable to capital gains and the sale of stock acquired through options. The vision of widening surpluses as far as the eye can see could quickly become a mirage.

Alternatively, faster than projected economic growth would increase the surplus if spending remains in check. Regression towards the mean is more likely. After all, Congress is in the business of granting tax preferences to special interest groups and increasing spending for them as well. Thus, it is unlikely that the policies on which the CBO projections are based will remain in tact. Waiting for surpluses may be like waiting for Godot.

Focusing on a decade of projected surplus is harmful for it deflects concerns away from a fundamental fiscal problem confronting the nation—how to increase national saving. The CBO's long-term outlook has the deficit rising to about 5 percent of GDP by 2030, and the Federal Debt rising to 100 percent of GDP by 2040. The relentless march of baby boomers into Social Security and Medicare benefits causes the present value of projected tax revenues to be less than the present value of promised benefits. In this sense, the structural budget deficit looms just beyond the veil of projected near-term surpluses.[2]

Without an improvement in long-term growth trends for the economy, future generations are going to pay higher taxes, receive less than promised benefits, or both. Should budgetary surpluses occur over the next decade, they will be insufficient to prevent this outcome. There are no surpluses to spend over the long haul. The sooner the problem is addressed the less difficult will be the adjustment.

Surpluses, Snake Oil and Social Security

Social Security cannot be saved by the projected surpluses as President Clinton implied. Any surpluses will be consumed by existing recipients and the government. The liberally applied snake oil that has confused and mislead the public regarding the financial health of the Social Security system is found in its trust fund. The idea that Social Security taxes are paid into a trust fund encourages individuals to believe that there is a storehouse of assets that will be the source of the payments they will receive upon retirement. Nothing could be further from reality. None of the money received by an individual will come from what he paid in over a lifetime. That money was redistributed to earlier retirees and consumed by other government programs. The same fate would await any surpluses credited to the trust fund. The trust fund consists solely of government IOU's—special issue treasury securities—not direct claims on specific earning streams generated by real plant and equipment. Future benefits payments will come from future taxpayers, if they are able and willing.

Since the baby boomers begin retiring in 2008 the ratio of retirees to workers will rise and huge shortfalls between contributions and benefit payments will begin to occur a few years later, creating mounting deficits and government debt. Tinkering around the edges with marginal changes in the retirement age and payroll tax rate and covered earnings will buy little time.

A fundamental fix is to alter economic policies to promote the saving and investment necessary to expand the rate of growth in the economy. One way to do this is to privatize the system. Individuals can provide more effectively for their well-being in retirement than can government. For example, if individuals born in 1970 invest the amount they currently pay in Social Security taxes in financial markets, they will receive an estimated six times the benefits they are scheduled to receive under Social Security.[3]

Moreover, there is a safety net in place for those who misplan or fall upon unfortunate circumstances—welfare, preferably delivered at the state or county level, as well as neighborhood charitable organizations.

However, eliminating Social Security has little political support. A more likely course is to patch the current system—raising the eligible retirement age, cutting the cost-of-living adjustment, increasing taxes or perhaps privatizing a compulsory system. There currently are many proposals for privatizing the existing compulsory system. David Altig and Jagadeesh Gokhale have a proposal that offers no reduction in promised benefits and no new taxes to finance the transition to a 401(k) scheme.[4] However, their plan must be implemented soon to be effective and it won't work at all after 2011.

A Higher Standard of Living

The key to a higher living standard in the future is saving. Budgetary surpluses are a form of saving. However, the projected surpluses come with projected high (by historical standards) tax revenue as a share of GDP. This does not bode well for stimulating private saving and investment, so necessary for improving the long term grow rate for the economy. Any surplus should be used to reduce marginal tax rates and all taxes on savings should be eliminated. Proposals for a consumed income tax, national sales tax or a flat tax to replace the current income tax system are steps in the right direction. Entitlement programs that shift resources away from savers to high consumption groups need to be reduced, capped or eliminated. Such actions will increase growth in domestic investments and the amount of capital per worker. A more productive labor force will command higher real wages. It is private saving and concomitant investment that will solve our long-term fiscal difficulties, not surpluses.

NOTES

[1]June E. O'Neil, "The Economic and Budget Outlook: Fiscal Years 1999-2008," Testimony to the Committee on the Budget, U.S. Senate, January 1998.

[2]For an extensive analysis of this issue see: "Generational Accounts for the United States: An Update," February 1998, Working Paper by Jagadeesh Gokhale, Benjamin R. Page and John R. Sturrock.

[3]William G. Shipman, "Retiring with Dignity: Social Security vs. Private Markets," Cato Institute Social Security Project No. 2, August 14, 1996.

[4]David Altig and Jagadeesh Gokhale, "Social Security Privatization: One Proposal," Cato Institute Social Security Project No. 9, May 29, 1997.