

BUDGET SURPLUSES AND THE FISCAL POLICY DEBATE

Mickey D. LEVY
Bank of America Corp
Shadow Open Market Committee
March 1999

The last time there was a debate about what to do with the fiscal surplus, in 1969, it ended quickly. Like today's debate, it occurred following years of sustained economic expansion and rapid growth of tax revenues. Since then, many things have changed; today's fiscal surplus likely will last longer, so the debate about what to do with it should be taken seriously. What underlies the budget improvement? Can the favorable trend be sustained? What should be done with the projected surpluses?

The shift from budget deficits to surplus has been driven by three factors: the Bush (1990) and Clinton (1993) tax hikes, spending cuts for defense and discretionary programs and, more importantly, rising tax receipts resulting from sustained economic growth, low inflation, and robust capital gains. Since the early 1990s, federal outlays have fallen from 22.5 percent of GDP to 19.6 percent in 1998, while tax revenues have risen from 18 percent to 20.5 percent, their highest level since 1944 (see Chart 1). Including the increases in state and local taxes, total government tax receipts have risen to 33 percent of GDP.

During this period, there has been a distinct change in the mix of spending. Entitlements have lived up to their name, and spending for them has represented the largest share of the rise in outlays, growing slightly faster than GDP (that is, they have grown in real terms). Net interest outlays have also risen, despite the ratcheting down in interest rates. Defense spending has been reduced sharply, while discretionary spending for domestic and international nondefense programs have declined modestly as shares of GDP (see Chart 2). Thus, while the spending caps imposed by the Balanced Budget Act of 1985 and the Budget Enforcement Act of 1990 have been successful in controlling government outlays, they also have contributed significantly to changing the mix of spending. This has continued a trend toward a smaller share of direct government purchases of consumption and investment goods, and a rising share toward transfer payments and redistribution. In fiscal 1998, social security and Medicare outlays

constituted 34.6 percent of total federal outlays, and 6.8 percent of GDP; compared to 1993, the share of GDP has edged up modestly from 6.7 percent, but the share of federal outlays has jumped from 30.9 percent.

The rising tax receipt share of GDP has been driven primarily by higher personal income tax receipts and a rapid increase in corporate taxes as a percent of GDP (see Chart 3). Personal incomes have grown consistently faster than GDP since 1992, and the progressive tax rate structure on personal income has generated bracket creep of real incomes. Capital gains have surged; approximately one-third of the growth in personal tax liabilities is accounted for by capital gains realizations. Further, the rapid increases in wages have lifted payroll taxes. As a consequence, the effective tax rate (personal taxes/adjusted gross income) has risen significantly, primarily for higher income households. The rise in corporate taxes as a share of GDP reflects primarily the robust growth in profits.

The decline in inflation through the 1990s has contributed significantly to the budget turnaround. Most importantly, it has been a key foundation for the sustained economic expansion and the surge in capital gains from stocks and bonds. Moreover, it has constrained the rise in spending through lower interest rates and lower COLAs on indexed entitlement programs.

The Budget Projections

Projections of sustained and rising budget surpluses involve tax receipts remaining high as a share of GDP and outlays declining continuously relative to GDP. Two trends in the current law (baseline) projections stand out. First, through 2003, virtually all of the projected declines in spending as a share of GDP are attributable to declines in net interest outlays (the Congressional Budget Office projects that they fall from 2.9 percent of GDP in 1998 to 1.8 percent in 2003 while total budget outlays fall from 19.6 percent of GDP in 1998 to 18.2 percent in 2003), while in the long-term projections (2004-2009), more than 100 percent of the decline in spending is attributable to the fall in net interest outlays. This reflects the combined impacts of projected low interest rates and declining outstanding debt, which cumulate over the projection period.

Noteworthy, publicly-held debt shrinks dramatically over the projection periods, while debt held by the government's trust funds (primarily social Security) rises significantly.

Meanwhile, the trends in the mix of noninterest outlays are projected to follow patterns similar to the 1990s, with mandatory spending for social security, Medicare and other entitlements rising faster than GDP, and spending on discretionary programs receding relative to GDP. The spending caps on discretionary programs are scheduled to expire in 2002; presently, there are rumblings about departing from the caps sooner. The CBO baseline assumes that spending on discretionary programs keeps pace with inflation beginning in 2003; projected surpluses would be even higher if dollar spending on these programs were assumed to be held constant following the expiration of the caps.

Second, the largest portion of the budget surpluses is attributable to the mounting cash flow surpluses in the social security trust funds. This complicates the interpretation of the projected surpluses and the debate about what to do with them, because social security is treated as a separate trust fund for accounting purposes, and because it has huge and rising unfunded liabilities that overwhelm its near-term cash flow surpluses. Social Security's unfunded liabilities are not captured by the government's unified cash flow budget.

Are the surpluses sustainable? Even setting aside the huge unfunded liabilities of the social security system, the sustainability of cash flow surpluses depends largely on their underlying economic, inflation and interest rate assumptions, and whether the fiscal policymakers can keep themselves from spending the projected surpluses—legislative slippage.

The assumptions underlying both the Administration's and the Congressional Budget Office's projections are generally reasonable, with no glaring inconsistencies (see Table 1). But as the CBO correctly details (*Economic and Budget Outlook: Fiscal Years 2000-2009*), just as everything so far in the 1990s has gone right in contributing to the dramatic turnaround in the budget, things could turn sour just as quickly. Consider the recent sharp rise in interest rates that has pushed them well above levels assumed for 1999; unless they retreat, net interest outlays will be higher than projected in 1999, with a cumulative affect throughout the budget projections. Similarly, a lot can change in the direction of fiscal policy. Following years of shrinking defense outlays, will national

security needs generate a larger reversal than is projected? Also, historically, the Administration and Congress have an abysmal track record of keeping their hands off projected improvement in the budget; is the Clinton Administration's Budget proposals a sign of future initiatives?

Fiscal Policy in Surplus Land

The options available to policymakers are: increase spending, cut taxes, do nothing (planning to reduce outstanding debt) and/or, as is now popular, “do something” about social security. President Clinton proposes to spend more—to raise outlays for a wide array of programs and selectively lower taxes through a web of narrow tax subsidies in an aggregate amount equal to approximately 32 percent of the projected cumulative surplus—and to save the rest, as the Administration states, for social security. The Administration's new spending initiatives are designed to look prudent fiscally—a relatively easy task in an environment in which a surprisingly robust economic expansion and stock market provide windfall budget surpluses—and to spread the newfound wealth in a way that buys the most votes. To quote Michael M. Weinstein, a reporter for the *New York Times*, “The litter of initiatives is breathtaking...The proposed budget sprinkles new spending across a huge array of programs, hardly missing a constituency or Congressional District.” (*NYT*, February 4, 1999). Another wrinkle is that faced with the constraints imposed by the caps on discretionary spending programs, the Clinton Administration initiatives rely in part on complex tax subsidies that reverse earlier initiatives toward tax simplification.

The Clinton Administration also proposes that a small portion of the projected budget surpluses set aside for social security be invested in the stock market, directed by a government passive investment strategy. The economic and political flaws in this proposal are clear, and it should be rejected at the outset.

This type of hodge-podge approach is misguided. It does not resolve social security's financing issue or address its structural flaws, and its crazy-quilt pattern of spending and tax initiatives are a throwback to outdated, unsavory pork-barrel politics. Such undisciplined fiscal policy generated past budget excesses and cumbersome tax

structures, and should be avoided. Moreover, it raises the issue of whether the basic assumptions of the discretionary spending caps are realistic.

Fiscal policymakers must remember that 1) the projected surpluses follow an unprecedented rise in government debt, and 2) budget outcomes are extremely sensitive to economic and financial conditions. It is prudent to assign a large band of uncertainty around the projected surpluses; they may evaporate as quickly as they have appeared. Moreover, including social security's unfunded liabilities, the present value of the government's budget is significantly negative.

For these reasons, presently the prudent approach is to save, not spend. Saving would begin to pay down the national debt. If outstanding government debt actually falls as rapidly as projected, a tax cut would be in order.

Presently, a tax cut may be justified as a way of returning a portion of the windfall surge in tax receipts stemming from the unsustainable robust economic and financial performance. Also, cutting taxes as a strategy to prevent spending the projected budget surpluses, particularly for more entitlements and transfers that do not add to productive capacity, would be wise. However, a tax cut followed soon by deterioration in the budget for whatever reason would create uncertainty and undesired policy instability. In addition, realistically, cutting taxes likely would involve the same degree of politics as current initiatives to spend more, and fiscal policymakers could quickly turn the idea of an across-the-board tax cut into a politically-driven giveaway. So saving the projected surpluses and reducing government debt and seeing if the projected surpluses materialize presently may be the most prudent policy.

Fixing social security is a separate and crucial issue. But the "fix" must go beyond taking advantage of the budget's cash flow surplus, and address social security's structural flaws. These flaws are not eliminated by not spending projected surpluses in the government's general fund, putting some funds earmarked for social security into the stock market, raising payroll (or income) taxes, or even making future benefits less generous than current law; rather, the flaws are more structural in nature, and the pay-as-you-go financing scheme must be replaced in part by a privatized system that accumulates individual wealth and pays it out, rather than simply effecting

intergenerational transfers amid demographic and other risks. Many of the alleged problems with such reform are illusory.

Addendum on social security trust fund accounting

The Clinton Administration proposes to reserve 62 percent of projected surpluses for social security. The “double-counting” allegation—that the President’s budget effectively makes double use of social security’s cash flow surpluses—is true in a literal sense, but it has also been true of every other President’s budget, whether the unified budget and/or social security cash flows have been in surplus or deficit. In reality, the President’s proposal neither helps nor hurts social security’s financing. To see this, consider the realities of the trust funds.

Social security’s trust funds track the program’s pay-as-you-go financing as a separate accounting entry; while it is accounted for outside of the unified budget, payroll tax receipts go into the government’s general fund and benefit disbursements are made from it and are part of the general fund’s total cash flow budget. Presently, social security’s unfunded liabilities are magnitudes larger than its projected cash flow surpluses, and the net unfunded liabilities are not reflected in either the government’s budget or the trust funds.

The separate accounting of the trust funds was established by the creators of social security to convey to the public the insurance aspects of social security; for the same reason, payroll taxes were called “contributions.” Social security’s separate accounting entry has continued to perpetuate the frayed notion of an insurance program, even as its benefit and tax structures have strayed afar.

In reality, there are no real assets in the trust funds. If you go to the Social Security administration headquarters in Baltimore, and ask to count the assets in the trust funds, there’s nothing there physically. When the social security is running a positive cash flow (as it has since 1983), the government effectively sends an IOU (puts a U.S. Treasury bond) into the social security accounting entry (trust fund); but in reality, the normal conduct of government finances does not distinguish between receipts and outlays in the unified budget and flows of the social security’s trust funds. So it is incorrect to count a \$1 IOU as an addition of real assets to the social security trust fund and to also

count is as a real addition to the government's cash flow budget; the Administration effectively double-counts when it counts not spending the projected budget surplus both as a reduction in government debt and as real asset to pay future social security liabilities.

Under current law and generally accepted demographic and economic assumptions, social security benefits will begin exceeding payroll tax receipts as the ratio of baby boom retirees overwhelms workers, around 2013. At that time, the trust funds will "register" outflows; that is, social security will begin to contribute negatively to the cash flow of the government general fund. Eventually, either taxes must be raised (either payroll taxes and/or income taxes), benefits cut, or the government draw down general revenues or borrow more.

Playing accounting games between the government's general fund and the social security trust funds does not change these realities of the unfunded liabilities or the timing of when they will come home to roost. Judging by the widespread confusion about how the social security trust funds work, the program's founders would be amused by how well their financing scheme has worked!