

Budget Surpluses and the End of Fiscal Restraint

Mickey D. Levy
Chief Economist
Bank of America

The era of fiscal restraint has ended, as the politics of surpluses have replaced the politics of deficits. The politics of deficits made its mark, fundamentally changing the nature and role of federal finances. The dramatic shift from cash flow deficits to surpluses involved reducing spending to its lowest portion of GDP since the 1960s and increasing tax receipts to an historically high share. The spending reductions were selective and uneven, dramatically altering the composition of spending by reducing the government's purchases of goods and services that directly absorb national resources, while significantly increasing the share of spending for entitlements and income redistribution. True tax reform in the 1980s (the Tax Reform Act of 1986), which lowered tax rates and broadened the base but had little effect on tax receipts as a percent of GDP, gave way to a series of tax hikes in the 1990s. The combination of legislated tax hikes, lower inflation, robust economic growth and capital gains has generated a bulge in tax receipts. Even though current law projections of mounting cash flow surpluses are too optimistic--they assume sustained high tax receipts as a percent of GDP and adherence to the legal caps on discretionary spending--they redefine the thrust of the fiscal debate.

The perceived flexibility provided by the politics of surpluses replaces fiscal restraint with new spending initiatives and tax reduction proposals. During the Presidential campaign, Vice President Gore proposed an array of new spending initiatives that would raise outlays for entitlements and retirement programs, and provide modest increases for national defense, while Governor Bush proposed more defense spending and countered Gore with modest increases in spending on the elderly and education.

Bush proposed a large and economically efficient tax cut, while Gore proposed numerous
s that would reverse earlier tax reform by re-
distortions to the tax base for social and income redistribution purposes.

A constant political holdover from the era of deficits is that Social Security
fact, the projected surpluses have only heightened the
political rhetoric about social security financing and added confusion to the debate about

Selective Fiscal Restraint and the Changing Nature of Government Finances

Fiscal restraint was en
buildup and the ending of the Cold War in 1990, and constrained by the political support
discretionary programs,
very uneven mix of spending cuts. About 59 percent of the reduction of government
defense. During thi
16.4 percent, and entitlements rose from 51 percent to 56 percent. Net interest outlays
early 1990s, tax receipts remained relatively stable as a percent of
generated under prior law, while the impact of several legislated tax hikes on tax receipts
d by the 1990 1991 recession. The most fundamental change involved the
eliminating many of the credits, exemptions and deductions that had been the source of
iciencies, inequities and complications. Tax policy in the 1990s was a
and a more progressive tax burden.

The earlier popular arguments for deficit reduction were based on the traditional notion that government spending would crowd out private investment and lower long-run economic growth, and concerns about the high current account deficit and reliance on foreign capital. The crowding-out argument proved prescient, but the presumed linkage between the budget and current account deficits was embarrassingly wrong.

The reduction in government spending and, more precisely, the decline in the government's direct purchases of consumer and investment goods (as distinguished from transfer payments that redistribute but do not directly absorb resources) as a share of output freed resources for private uses. This was one factor that contributed to the private investment boom and rapid economic growth of the 1990s. Note that this argument depends less on the reduction in government budget deficits and more on the reduction in government purchases themselves.

In contrast, the notion that reducing budget deficits would increase national saving and reduce the current account deficit was based on a flawed framework and some wrong assumptions, for example, that private saving and investment would remain unchanged as the government's finances changed. In fact, while the budget has shifted dramatically from record-breaking deficit to a surplus of 2.4 percent of GDP in 2000, the U.S. current account deficit has widened to an historic high of 4.4 percent of GDP.

The dramatic shift from government deficits that drained national saving to cash flow surpluses that now add to saving has been fully offset by the sharp decline in private saving. While business saving has remained relatively unchanged as a percent of GDP, as the government has gone from dissaving 2.5 percent of GDP in 1992 to saving 4.0 percent of GDP (including federal, state and local governments), household saving has fallen from 6.5 percent of GDP to virtually 0.0 percent in 2000. Whether this reversal reflects the sharp rise in household wealth-to-income ratios and consequent decline in the perceived need to save from current income, or whether households perceive less need to

save because they believe the shift to government saving eventually will lower taxes, the outcome is strikingly consistent with the concept of Ricardian equivalence.

The rising current boom (rather than any profound change in national saving) and the surge in net capital inflows into the U.S. Robust investment (it has risen to 15.2 percent of GDP from 9.2 percent) has outpaced national saving, while net capital inflows into the U.S. have been attracted by the high expected rates of return on U.S. dollar denominated assets relative to assets denominated in foreign currencies. The relative attractiveness of dollar-denominated assets was accentuated by the Asian crisis that unfolded in late 1997, which pushed the real interest rate on U.S. dollar denominated assets up from 4.5 percent of GDP to nearly 4.5 percent. Critically important, while the government's budget surplus in the last 10 years, approximately 70 percent of the sharp rise in imported goods have been capital goods and industrial materials. This enhances productive capacity and direct foreign investment has risen sharply and now constitutes the largest share of net capital inflows.

Two other observations about the shift from deficits to surplus. First, the fiscal restrictiveness measured in a standard Keynesian sense did not contract the economy. In fact, deciphering even a negative short run effect of deficit reduction is difficult. Second, the earlier presumption that deficit reduction would lead to lower interest rates has not unfolded as anticipated: real interest rates have risen, associated with robust economic performance and high expected rates of return on investment, while market interest rates have risen, reflecting strong inflationary expectations.

Budget Outlook and Proposals

Current Law Projections

Congressional Budget Office and the Clinton Administration that underline the political

environment for new spending and tax cut initiatives--approximately \$4.6 trillion cumulative in the next 10 years through 2010, \$2.3 trillion excluding Social Security's cash flow surpluses--are overly optimistic. In the CBO's most recent projections (*The Budget and Economic Outlook*, July 2000), government spending shrinks dramatically, from 18.2 percent of GDP to 15.6 percent in 2010, as net interest outlays all but disappear with the near elimination of publicly-held debt and spending on discretionary programs declines further, while social security and retirement programs continue to grow, eventually constituting over 70 percent of all government spending. Tax receipts as a percent of GDP remain very high.

These projections are based on realistic economic assumptions but unrealistic assumptions about adherence to the legal spending caps on discretionary programs, and continued rapid growth in personal income tax receipts. The CBO's assumption of 3.1 percent annualized growth from 2000-2010 and the Administration's 3.0 percent are conservative relative to current standard forecasts; their assumptions about stable, low inflation and interest rates are also reasonable. However, other key assumptions are on shaky ground; a more realistic interpretation of current law projects significantly lowers surpluses. Moreover, payroll taxes and cumulative social security trust fund surpluses are overwhelmed by the program's unfunded liabilities, and adding them to the unified budget surpluses is inappropriate.

Firstly, by law, the CBO is required to assume adherence to the discretionary caps, even though they already have been violated, and keeping spending within their future limits will require rigid spending cut legislation, an unlikely outcome in the current "spend the surplus" environment. Spending on non-defense discretionary programs already has been reduced significantly, to 2.2 percent of GDP in 2000 from 2.9 percent in 1983. A more realistic assumption is appropriate. As a guideline, if discretionary spending is assumed to remain a constant share of GDP rather than falling significantly further, total spending would be more than \$700 billion higher over the ten year projection period; including the impact on net interest outlays, cumulative surpluses

would be over \$800 billion less (see Alan Auerbach and William Gale, *Perspectives on the Budget Surplus*, NBER Working Paper #7837, August 2000).

Secondly, the CBO assumes that the recent bulge in personal income tax receipts as a percent of GDP--they have risen to 10.0 percent, up from an average of 7.8 percent average in the first half of the 1990s--will be maintained. This sharp rise has been generated by robust economic growth and the spurt in capital gains and exercised stock options, which have been magnitudes higher in 1999-2000 than in the mid-1990s. Importantly, exercised options are taxed as ordinary income, raising effective tax rates. If personal income tax receipts average 9.6 percent of GDP--a scant 0.4 percentage point retracing of their recent rise--tax receipts would be nearly \$500 billion lower than projected during the next 10 years. This would also push up net interest outlays. Combined, these outcomes would generate surpluses less than half those projected under current law.

Spending and Tax Initiatives. Spending on discretionary programs exceeded the legal caps in 2000, and newly enacted spending increases for foreign aid, depressed communities and small businesses, and targeted tax credits that subsidize long-term health care and insurance premiums add up to approximately \$40 billion in 2001 alone.

The political turmoil surrounding the Presidential election heightens uncertainties about fiscal policy. The razor-thin election outcome tempers the President's mandate, and the nearly-split Congress will be highly partisan. The large surpluses may afford a comfort zone for political compromise. The political backdrop is intriguing: during the election campaign, Congressional Republicans gave only lukewarm endorsement of Bush's tax cut proposal; they favored higher subsidies of pharmaceutical drugs for the elderly, but generally rejected Vice President Gore's proposed array of new spending initiatives and targeted refundable tax credits. Congressional Democrats favor more spending on social programs, modest increases in defense spending, but clearly favor Gore's targeted tax cuts over Bush's across-the-board tax cuts. Budget scorekeeping takes center stage once any fiscal package is proposed as legislation. Bush's proposed tax cut

would be phased in gradually and its "static analysis" budget impacts would be fairly
legislation, and their budget impacts would be much more complex to measure. In
general, Bush's tax cuts would increase ec
horizontally and vertically). The primary debate centers on their magnitude relative to
projected surpluses and the broader issue of the proper allocation of national resources
ors, and the role of the government in redistributing
wealth. Among other complexities in Gore's initiatives, his targeted tax credits
budget as spending increases because they are refundable. Some of Gore's spending

Reintroducing an extensive array of targeted refundable tax credits to subsidize selected
activities represents a cl reversing the earlier base
broadening and loophole- -establishing an uneven pattern of

A Clarification on "Lock Boxes" and Social Security Financing

promise to establish "lock boxes" that set aside funds to pay for Social Security and
Medicare benefits forwarded in the attempt to win the electorate's trust that those
programs' benefits will not be cut and t --in reality has little

funds to pay for Social Security and Medicare benefits, regardless of whether their
respective trust funds have positiv
funds are locked away for specific purposes. Period.

The program's financing procedures clarify this point. Social Security and
Medicare's trust funds track the programs' pay as- -go financing as se
accounting entries; while they are accounted for outside of the unified budget, payroll tax
receipts go into the government's general fund and benefits are disbursed from it and are
al Security and
Medicare's unfunded liabilities are magnitudes larger than their projected cash flow

surpluses, and their net unfunded liabilities are not reflected in either the government's budget or the trust funds.

In reality, there are no real assets in the trust funds. 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.

Creating "lock boxes" to guarantee funds dedicated to these programs is nonsense. Any "lock box" in fact would be merely the same type of collection of IOUs from the government to itself that currently constitutes the accumulated trust fund surpluses. Their only implication--that general funds would be used to fund social security, which violates the original "insurance" aspects of the programs--in reality is nothing new. 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. Medicare benefits will continue to rise relative to the Hospital Insurance portion of payroll taxes, and Social Security retirement benefits eventually will exceed payroll tax receipts and the trust funds will "register" outflows; that is, social security will begin to contribute negatively to the cash flow of the government general fund. Benefits still will be disbursed. Eventually, either taxes must be raised (either payroll taxes and/or income taxes), benefits cut, or the government must draw down general revenues or borrow more. "Lock boxes" just confuse the issue.

A Clarification on Social Security Reform. Allowing workers to allocate a small portion of payroll taxes into segregated accounts (that they could manage) would reduce the flows into the government's general funds and the accounting entries for the Social Security's trust funds, but would also reduce the government's unfunded liabilities. On an accrual basis, nothing changes; the payroll taxes diverted into personal accounts are offset by reduced future government benefit obligations. On a cash flow basis, the drain on payroll tax receipts precedes the reduction in social security benefits, so the trust

funds register quicker erosion, but benefit in the long run.

addressed, but since the cash flows of the general fund and the social security trust funds are commingled, these transition financing issues are not insurmountable.

A Note on Monetary Responses to Fiscal Policy

The Fed must

-run economic impacts of

-run objective of

or should be adjusted to fiscal policy to achieve desired economic outcome assumes that

the lagged economic impacts of changes in fiscal policy are predictable, and that fiscal poli

shown repeatedly the fallacy of each of these assumptions.

The differences between fiscal and monetary policy are clear. While fiscal policy is incapable of generating allocation of national resources and influences long-altering incentives to consume, save and invest. In contrast, monetary policy is an aggregate demand tool that is no -term productivity or output,

capacity. Changes in the size of the deficit (or surplus), however calculated to control for the economic c

misleading forecasts of economic outcomes. In fact, without making grand after- -fact

tell whether the fiscal policy "multipliers" are positive or negative. Attempts to adjust

the Fed

must not jeopardize its credibility, or inadvertently influence the fiscal policy debate, by