

Federal Reserve Bank of Cleveland

Fiscal Policy in an Era of Surpluses

by Jagadeesh Gokhale

Advocates of limiting government outlays via tax reductions view the U.S. economic experience during the last two decades as vindication: Constraints on public-sector growth may have been the most important contributor to the longest economic expansion during the postwar period. Indeed, but for a minor hiccup during 1991—one not attributable to fiscal policy—this approach has yielded almost two decades of prosperity. Now, however, in a mind-bendingly short period of time, worries about a debt crisis have been supplanted by concerns over large accumulating surpluses.

Although we may feel dizzy with our success in stemming the tide of federal red ink, the surpluses now threaten to unravel the very consensus favoring limited government that delivered today's brighter budget picture. Since 1998, discretionary spending has outpaced inflation, and Congress's current spending proposals and recent actions suggest that discretionary spending limits in force through fiscal year 2002 will not remain effective.

The surpluses have reinvigorated the perennial tug-of-war in Congress over how revenues should be used. The recently passed Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) devotes about a quarter of the projected 10-year surplus for tax cuts. In addition, Congress has resolved to increase mandatory outlays during the next 10 years. However, at least for a few more years, the 10-year cumulative surplus will grow larger as the projection window shifts forward and early low-surplus years are replaced by later high-surplus ones. Despite the recent tax cut, heightened policy battles pitting deeper tax cuts against increased federal spending may continue for a while yet.

Should taxes be cut further? Should the remaining surplus be devoted to paying down the national debt? Or should outlays on education, health, social programs, and public infrastructure be increased? These questions are complicated because the surpluses are unlikely to continue for long: Social Security and health care outlays are expected to surge during the second decade of this century to support the growing share of elderly in the population. The increases projected in entitlement outlays are substantial and threaten to crowd out spending on other programs unless taxes can be increased to compensate.

Under such a long-term outlook, a temporary period of accumulating federal surpluses constitutes a double-edged sword: It presents an opportunity for implementing fiscal reforms but also creates the risk that lawmakers will assume additional spending commitments, worsening the already ominous long-term budget picture. This *Economic Commentary* reviews how today's budget outlook was achieved and evaluates the fiscal choices policymakers must now grapple with.

■ Federal Budget Developments: Past and Present

Since Ronald Reagan made limiting the size and scope of government the centerpiece of his first presidential campaign, considerable progress has been made toward reducing tax burdens and limiting government outlays. The tax cuts of the early 1980s reduced personal and corporate income taxes from 11.3 percent of gross domestic product (GDP) in 1981 to 9.3 percent by 1984.¹ However, the Reagan tax cuts were not immediately matched by lower government outlays, and federal deficits surged as a result. The "exploding-peacetime-debt" crisis that followed prompted significant consolidation and downsizing of government agen-

Federal surpluses have come as a pleasant surprise, but using them to finance additional government spending would be disastrous. By the middle of the next decade, Social Security and Medicare outlays will soar beyond projected payroll taxes. While using the surpluses to offset future entitlement payments is a good idea, finding a way to do it is not so easy. This *Commentary* suggests it could be accomplished by paying down the national debt and combining the remaining surplus with Social Security reform.

cies during the late 1980s. Income tax reform during the mid-1980s lowered marginal tax rates yet again, reduced the number of tax-rate brackets, and broadened the tax base to make the tax system simultaneously lighter and fairer. These initiatives to limit revenue growth ultimately succeeded in reining in federal discretionary spending—it slid from 10.1 percent of GDP during 1981 to below 9 percent by the end of the decade.

Concern over inefficiencies and disincentives that the welfare system generated for recipients motivated its retrenchment and redesign during the 1990s. Continued high deficits and debt prompted Congress to enact the Budget Enforcement Act in 1990 (BEA), which extended and reinforced the spending restrictions first introduced in the Deficit Control Act of 1985. As a result, federal discretionary spending continued on a downward trend and today amounts to 6.3 percent of GDP.

Despite two increases during the early 1990s, statutory marginal income tax rates are much lower today compared to two decades ago. However, strong economic growth has pushed *effective* average tax rates to postwar highs. Personal and corporate income taxes amount to 12.7 percent of GDP today—a 30-year high. Moreover, total federal revenue as a share of GDP has achieved a postwar high of 20.7 percent.² These shares will probably rise further as taxable pension-plan withdrawals accelerate and higher productivity and real income growth continue to push households into higher income tax brackets. Lower federal discretionary spending has also contributed to the improved fiscal picture: For example, defense purchases *fell* at an average annual rate of 3.0 percent during the 1990s compared to average annual growth of 3.6 percent during the 1980s.³

Higher effective taxes and lower discretionary outlays have led to a surge in federal surpluses. The Congressional Budget Office's January 2001 projections place the 10-year (2002–2011) cumulative surplus at \$5.6 trillion. Of this, \$2.5 trillion accrues “off budget” (in the Social Security and Postal Service accounts) and \$3.1 trillion accrues “on-budget.” Estimates by the Joint Committee on Taxation suggest that the recently enacted tax cut will reduce the 10-year on-budget surplus by about \$1.7 trillion (including interest costs). If Congress delivers on its mandatory spending resolution, the on-budget surplus will be reduced by another \$540 billion (again, including interest costs). Thus, of the \$5.6 trillion 10-year cumulative surplus, \$2.5 trillion (off-budget) and approximately \$900 billion (on-budget) remains uncommitted.

■ Spend the Surplus?

The option of spending at least some of the \$3.4 trillion uncommitted surplus appears attractive to many. Public spending on some types of goods and services is justified if markets fail to provide them in sufficient quantity—roads and judicial systems, for example—and it is generally recognized that such spending should grow with the size of the economy. However, taking a long-term perspective, restoring the pre-BEA spending trend is likely to make the budget situation worse. Apart from reversing two decades of progress toward limiting the scope of government activity, additional federal spending will increase not just current outlays but escalate future spending com-

mitments as well. This is true of most of the additional spending legislation currently being considered by Congress, such as a prescription drug benefit for the elderly, education assistance, and labor and health programs.

Taking on additional spending commitments based on a cumulative 10-year surplus would be hazardous: Social Security and Medicare outlays are projected to surge as the baby-boom generation begins to retire—in about 10 years.⁴ Under current payroll tax rates, these outlays will outstrip revenues after the middle of the next decade, putting pressure on the rest of the budget. To meet burgeoning entitlement outlays, either spending on other federal programs will have to be cut back or taxes will have to be hiked. According to a recent estimate, the Social Security payroll tax rate—currently at 12.4 percent—will have to rise by another 6.4 percentage points in order to maintain current-law benefits into the future.^{5,6}

If Congress spends the uncommitted funds on new or expanded programs, future generations will be left with the tab for future Social Security benefits, servicing the still-outstanding national debt, and a higher rate of federal spending. The implied high tax burdens will severely dampen future work incentives and may slow the pace of economic growth. Given this long-term outlook, it seems more appropriate to preserve the uncommitted 10-year surplus for funding future Social Security, Medicare, and other mandatory outlays. Securing the uncommitted surplus for this purpose, however, is not an easy task.

■ Save the Surplus?

Can the government conserve the surpluses and devote them to anticipated increases in entitlement outlays?⁷ After all, Congress did enact the Budget Enforcement Act in 1990, which imposed strict caps on discretionary spending and required that changes to entitlement outlays be financed on a pay-as-you-go basis—constraints that later Congresses did not breach, for the most part.

However, the BEA was a response to immediate and explicit political pressure brought on by escalating federal deficits and debt. *Prospective* deficits and debt are much less likely to provoke similar belt-tightening. On the contrary, the prospect of large budget surpluses has re-ignited Congress's willingness to con-

sider additional spending initiatives—demonstrating that political incentives exert tremendous pressure to immediately appropriate available resources on existing or new spending programs.⁸ The uncommitted federal surplus remains in jeopardy of being spent.

Even if the government successfully abstains from spending the surpluses, what would it do with the cash? It would have to be invested somewhere (to avoid a severe contraction in the monetary base). Investing the funds in private-sector assets implies direct ownership of enterprises by the government, increasing the likelihood that political considerations rather than market price signals will determine business decisions.

Hence, greater federal ownership of assets is likely to make resource allocation less efficient—the same outcome as if the government were to directly spend the surplus. This is true notwithstanding the possibility that the government may invest the surpluses in roads, airports, and basic science, whereas the private sector may invest them in McDonald's franchises and baseball teams. As the economic disasters in former socialist countries demonstrated, central direction rarely generates greater productive capacity in precisely the types and quantities of goods and services desired by the public. Private allocations work better because they result either in consumption according to private preferences or investment based on prices that signal future consumption preferences.

■ Pay Down the Debt?

The simplest way to preserve the off-budget surplus to pay for future mandatory outlays is to pay down the national debt. This is a good policy not because of an idealistic notion that low debt is good. Indeed, financing public expenditures by issuing debt is sometimes more appropriate. It is desirable simply because it will prevent greater federal spending, larger future spending commitments, and a larger government role in allocating resources.

Although paying down the debt held by the public is desirable, it is unlikely that *all* of the debt outstanding will be redeemed within the next 10 years without sizable additional cost. The Congressional Budget Office estimates that about \$800 billion of long-maturity Treasury securities will remain outstanding after 2011 because debt holders value highly

their safety and liquidity. Of course, the debt holders will part with their Treasury securities at higher prices, but it may take much more than \$800 billion to buy them back. Assuming that only \$2.5 trillion of the \$3.3 trillion outstanding national debt can be paid down within 10 years, the government stands to accumulate a cash balance of about \$900 billion by 2011. Again, note that this sum pertains to the 10-year budget window spanning 2002–2011. It is likely to grow as the window shifts forward over time—until Social Security outlays start depleting it.

■ Expand the Tax Cut?

If both increased government spending and federal investments in private capital markets are undesirable, extending the recently enacted tax cut seems to be the only option left for the surplus remaining after paying down national debt as much as possible. This might be done by phasing in the cuts earlier, extending the recent tax cuts well beyond 2011, or making the cuts deep enough to exhaust the surpluses.

Would this be a good policy? Deepening or extending the tax cut would grant the current working generation (the baby boomers) a windfall. But we know full well that this same generation's retirement and health benefits will have to be financed by levying much higher taxes on the next generation of workers. Deepening the tax cut would also exacerbate volatility in tax rates over time, which goes against the well-known economic prescription of keeping tax rates constant over time.⁹

If the baby boomers were granted and saved most of an additional tax cut for future retirement and health expenses, future entitlements could be cut and future payroll-tax hikes minimized. So why don't we strike a "deal" with the baby boomers that would trade a deeper tax cut today for a reduction in their future Social Security benefits? Executing such a compact directly is obviously not feasible: Even if it were, retired baby boomers will constitute a potent political force in the future and would seek to restore or increase Social Security and Medicare benefits.

If the tax cut is extended with no quid pro quo, boomers will perceive it as a more certain and permanent increase in their lifetime resources and, therefore, will spend rather than save most of it.

Advocates of a deeper tax cut argue that it will further improve work and entrepreneurial incentives and promote faster economic growth. To the extent that this leads to permanently faster economic growth, the tax bite on future workers for financing future entitlement outlays will become lighter. However, past experience suggests that such effects are unlikely to be large.¹⁰

■ Two Birds, One Stone: Social Security Reform

Although explicit national debt is not large enough to "mop up" the entire uncommitted surplus, there is plenty of implicit debt. As mentioned earlier, federal benefit liabilities for Social Security alone far exceed projected payroll taxes, and the difference represents implicit federal debt. Estimates place the amount of the debt at \$8 trillion.¹¹

A potentially straightforward way of devoting uncommitted surpluses to future entitlement outlays would be to convert implicit Social Security liabilities into explicit national debt. This may be achievable under a Social Security reform that establishes individual accounts for all workers.

The Social Security benefit liabilities that have accrued to the next generation of retirees are relatively certain and will come due relatively soon. These liabilities could be converted into explicit debt by crediting an equivalent amount of marketable Treasury securities to future retirees' new Social Security individual retirement accounts.

Although withdrawals would be prohibited until after retirement, the portfolios within these accounts could be re-adjusted—according to individual preferences—by exchanging some of the newly issued Treasury securities for private stocks and bonds. Such portfolio readjustments would make the newly issued Treasury securities available for redemption by the government.

Many have argued that an individual-accounts-type Social Security reform would place that system on a sounder financial footing. In addition, individual accounts would enable workers to invest their retirement funds in higher-yielding private assets and bequeath them to their children and grandchildren upon death. Moreover, converting future Social Security implicit liabilities into explicit debt will lend greater visibility to future

federal expenditure commitments, which may induce the government to spend less today. Finally, it may educate today's workers about how small their Social Security nest egg really is and induce them to save more.¹²

■ Conclusion

The emergence of large federal surpluses due to surging revenues and declining defense spending now threatens to unravel the earlier consensus favoring limited growth in government outlays. The surpluses have reinvigorated the tug-of-war in Congress over allocating federal dollars. Political and economic incentives incorporated in the appropriations process make it very difficult to prevent the government from spending available revenues. Even if the government successfully amassed a large sum of assets, its allocation among alternative uses would be subject to political influence and would be less economically efficient.

Deepening and extending the recently enacted tax cut also seems undesirable because its main recipients—the baby boomers—seem likely to spend rather than save it for their own retirement. Despite claims to the contrary, extending the tax cut is unlikely to generate stronger work incentives. The most preferable alternative seems to be to combine the surpluses with an individual-accounts-type Social Security reform—one that will put that program on a sounder financial footing and earmark uncommitted surpluses for meeting benefit liabilities that will come due in the not-too-distant future.

■ Footnotes

1. These numbers, which pertain to fiscal years, are taken from the Congressional Budget Office's *Budget and Economic Outlook: Fiscal Years 2002–2011*, January 2001.

2. These numbers are calculated from the Bureau of Economic Analysis's National Income and Product Accounts.

3. These figures are on a calendar-year basis and are calculated from the Bureau of Economic Analysis's National Income and Product Accounts as national defense consumption plus gross investment less national defense consumption of fixed capital.

4. Under current projections, this will occur in 2016. See the March 2002 Social Security Trustees' Annual Report.

5. See "Simulating a Way out of America's Demographic Dilemma" by Laurence J. Kotlikoff, Kent Smetters, and Jan Walliser, mimeo, February 2001.

6. Overall, the CBO's long-range projections indicate that public spending on major health and retirement programs will double from 7.5 percent of GDP in 1999 to 16.7 percent by 2040. See the CBO's *Long-Term Budget Outlook*, October 2000.

7. Although many politicians speak of "saving" the off-budget surpluses for Social Security, no credible mechanism (a truly secure "lock box") exists that can guarantee this outcome. By law, the off-budget surplus must be invested in Treasury securities—making them available for current federal spending.

8. The House Appropriations Committee recently nearly doubled the President's request for \$6.5 billion in supplemental spending for fiscal year 2001 and recently approved an appropriations bill for \$18.9 billion in new spending on natural resources and energy. Approvals of spending initiatives on labor, health, and education, exceeding the ceiling specified in this year's budget resolution by \$4 billion, are reportedly being considered.

9. A well-known theorem in economics says that economic losses rise with the square of the tax rate. Hence, a system that smoothes tax rates over time is preferable to one where tax rates are volatile. For example, suppose that tax rates of 1, 2, and 3 percent generate losses of 1, 4, and 9 percent respectively.

Maintaining the tax rate at 2 percent over two periods is preferable to keeping it at 1 percent in the first period and 3 percent in the second.

10. See, for example, "Evidence on the High Income Laffer Curve from Six Decades of Tax Reform" by Austan Goolsbee, *Brookings Papers on Economic Activity*, vol. 2, 1999, pp. 1–47.

11. See "Social Security's Treatment of Post-war Generations: How Bad Can It Get?" by Jagadeesh Gokhale and Laurence J. Kotlikoff, National Bureau of Economic Research, Working Paper no. 7362.

12. A recent study suggests that, notwithstanding Social Security benefits, most of today's pre-retirees need to save significant fractions of their incomes to maintain their living standards during retirement. See "How Much Should Americans Be Saving for Retirement" by B. Douglas Bernheim, Lorenzo Forni, Jagadeesh Gokhale, and Laurence J. Kotlikoff, *American Economic Review*, Papers and Proceedings, May 2000.

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