Strong economic growth in the U.S. has produced a federal budget surplus for the second consecutive year: $124 billion for fiscal year 1999 on the heels of 1998’s $69 billion surplus. The surpluses are projected to continue and, indeed, to increase if Congress adheres to its current discretionary spending policy. The size of future surpluses, however, depends on the precise interpretation of “current discretionary spending policy.”

The cumulative surplus for the period 2000–10 is projected to be $4.2 trillion if discretionary spending is kept within statutory caps in 2001 and 2002 and allowed to grow with inflation thereafter. An almost identical cumulative surplus is projected if discretionary spending is frozen in nominal terms at its fiscal year 2000 level. Alternatively, if Congress allows discretionary spending to grow at the same rate as inflation, the cumulative 2000–10 surplus will be smaller—$3.1 trillion.

The main factors underlying federal surpluses are strong revenue growth and declining discretionary spending. During fiscal 1998 and 1999, federal personal plus corporate income taxes exceeded 11.5% of GDP for the first time since the late 1960s. At 6.3%, federal discretionary spending as a share of GDP is at a post-World War II low. Depending on which policy assumption is adopted, discretionary spending falls to between 4.2% and 5.3% of GDP by 2010. In addition, budget surpluses imply a decline in federal debt relative to GDP and, hence, lower servicing costs. As a result, net interest outlays fall from 2.5% of GDP in fiscal year 1999 to only 0.5% of GDP in 2010.

The current economic boom is historically unique. It has already outlasted the longest previous growth spurt. It has also reversed the decline in income tax revenues that began with the recession and... (continued on next page)
The Federal Budget (cont.)

NOTE: All data are for fiscal years.
SOURCE: Congressional Budget Office.

marginal rate cuts of the early 1980s. Since that time, sustained increases in earnings and asset income, the partial reversal of tax rate cuts in 1993, and the strong surge in asset prices since 1995 have swelled U.S. income tax revenues.

Larger incomes have shifted some Americans into higher tax brackets, and much of the recent income growth has been concentrated at the upper end of the income distribution. In addition, the strong surge in asset prices has raised the rate of asset turnover, increasing revenue from capital gains taxes. Indeed, the share of income taxes paid by households at the top 0.5% of the income distribution has jumped from 19.7% in 1990 to 24.2%. These higher income tax revenues, along with reduced discretionary spending in the 1990s, have transformed the federal budget; it has gone from producing deficits in the 1980s and 1990s to generating large projected surpluses in 2000 and beyond.

The decline in discretionary spending during the early 1990s can be traced to post-Cold War defense cutbacks—retrenching personnel, forgoing replacement of old equipment, and reducing new acquisitions. Although defense spending has bounced back since 1996, it has grown more slowly than the overall rate of inflation. Growth in nondefense spending, which outstripped the overall inflation rate during the early 1990s, slowed in the latter half of the decade.

Generational accounts show the present values of future taxes minus transfers for Americans who were alive in a given year. The calculations use survey data on distribution of taxes and transfers and the Congressional Budget Office’s July 1999 baseline projections of spending within statutory caps. Generational

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accounts for 1998 show a significant life-cycle pattern: Older generations are net recipients because the transfers they will receive—Social Security and Medicare benefits—exceed the taxes they will pay in the future. The opposite is true for working-age generations, who will pay taxes for several years before receiving transfers.

Given projected federal purchases and assuming that living (including newborn) generations will continue to be treated under 1998 policy, future generations’ net taxes must be higher, on average, than those of 1998 newborns to balance the budget over the indefinite future. With spending capped, future generations’ lifetime net tax rate (their generational account as a fraction of their lifetime labor income) will be 29.2%—14% larger than the 25.6% rate faced by 1998 newborns. The difference becomes still greater if federal purchases are assumed to grow at the same rate as GDP or if the ratio of future federal income taxes to GDP equals 10.4%, its average since 1970.

Restoring intergenerational balance to U.S. fiscal policy requires hiking taxes or cutting transfers so that living generations face larger net taxes and future generations face smaller ones. For example, under the capped-baseline assumption, all taxes would have to rise 2% immediately and permanently. Bigger hikes are required under the other assumptions mentioned earlier. Alternatively, government purchases could be reduced from projected levels (not shown). Moreover, postponing policies for restoring a generationally balanced fiscal policy makes the required policy changes larger.

a. Future generations