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In 1997 the US President and Congress concluded an agreement that imposed caps on discretionary government spending and which was expected to balance the budget by the year 2002. Just one year later the tide has turned: the fiscal year 1998 resulted in a US budget surplus for the first time since 1969. This article discusses the causes for this surprising development and the link between budget surpluses and Social Security’s finances. It also relates some recent proposals on how to preserve the budget surplus for Social Security to the sustainability of fiscal policy.

During the last two years the financial position of the United States government has changed dramatically. In 1997, the President and Congress agreed upon a path of government expenditures and revenues that was expected to balance the budget by the year 2002. Just one year later budgetary balance has been achieved. According to the United States Treasury, the fiscal year 1998 that ended in September closed with a surplus of approximately $70 billion. That figure is equal to about 0.9 percent of gross domestic product (GDP).

Moreover, the budgetary picture has also brightened in the medium term. The Congressional Budget Office (CBO), a non-partisan institution that provides budgetary and economic analysis to the United States Congress, expects in its August 1998 report that surpluses will last for the next 10 fiscal years. Those projections assume that the budget surpluses would be used to reduce the government debt held by the public.

However, CBO also reports that despite the overall improvement of the budget outlook, current fiscal policy is unsustainable in the long run. Results from CBO’s long-term budget model show that without changes to current tax laws or benefit rules large deficits would arise after the year 2030 such that the ratio of federal debt to GDP would grow without bounds. The long-run deficits stem largely from two federal entitlement programs: Social Security, and Medicare and Medicaid. Social Security pays benefits to retirees, the disabled and their survivors, and Medicare finances health care for the elderly. Medicaid is a welfare program that finances health spending including expenditures for nursing homes for people with limited means. Because the US population is aging and health expenditures are expected to rise faster than GDP, the long-run cost of the two entitlement programs exceeds their revenues from payroll taxes.

In his State of the Union Address in January, President Clinton linked the budget surplus to the financial health of the Social Security program. He declared that Congress should “save Social Security first” before any budget surplus is spent for other purposes. The Clinton Administration also emphasized Social Security’s future by organizing discussions of Americans with the President, Congressional leaders from both parties, and policy analysts in meetings across the United States. For early 1999, a conference on Social Security is planned in the White House.

This paper discusses the causes for the budget surplus and the link between budget surpluses and Social Security’s finances. It also relates some recent proposals on how to preserve the budget surplus for Social Security to the sustainability of fiscal policy.

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Origin and Sustainability of the Surplus

As early as two years ago, achieving budgetary balance appeared to be a difficult task. Policymakers were talking about "deficits as far as the eye can see". The agreement between the President and Congress in 1997 imposed caps on discretionary spending, but at that time it seemed as if it would take five more years to balance the budget. Just one year later the tide has turned and some policymakers now talk about "surpluses as far as the eye can see". What are the reasons behind that quick turnaround and how long will surpluses last?

A shrinking budget deficit can reflect a restriction of spending growth, an increase in revenue growth, or a combination of both. Usually a booming economy contributes to shrinking deficits by disproportionately raising income tax revenues. If the tax system is progressive, rising incomes lead to a more than proportional growth in revenues. Moreover, economic growth usually reduces spending on welfare and unemployment support. However, economic growth alone cannot explain the emergence of the 1998 budget surplus. Neither are spending cuts the driving force behind the current surplus because the 1997 caps will mostly affect future budgets.

Instead, the main reason for the budget surplus is the surprising and largely unexplained additional tax revenues. Those additional revenues exceed what could be expected from recent economic growth alone. Therefore, both the President's Office of Management and Budget and CBO have underestimated revenues in recent years. For example, in its original forecast for fiscal year 1998, CBO underestimated revenues by $53 billion. Only $7 billion can be explained by an underestimation of economic growth, $1 billion are a result of policy changes, but the remaining $45 billion are a reflection of yet unknown factors.

CBO explains in its August 1998 report that three factors contributed to an underestimation of tax revenues in 1996. Because tax return data was unavailable, the reasons for underestimating revenues could not be analyzed for fiscal year 1998. The latest available data are from 1996.

First, statistical problems made the measurement of tax bases difficult. GDP can be calculated either as the sum of expenditures or the sum of incomes, and both methods should come to the same result. However, in recent years a large and unexplained statistical discrepancy between the two measures of GDP has emerged. Apparently, the measured sum of incomes has grown faster than the measured sum of expenditures. It is unclear which of the two measures more accurately reflects the actual change in GDP. Commonly, GDP is reported based on expenditures. However, if the sum of incomes more accurately reflects the growth of GDP, predicting tax revenues based on total expenditures would lead to an underestimation of revenues. The tax revenue to GDP ratio has reached 20.5 percent in 1998, a post-war high for the United States.

Second, incomes did not rise by the same percentages in all sectors of the economy. The 1996 data indicate that how incomes of corporations and individuals with higher than average marginal tax rates rose faster than elsewhere in the economy.

Third, the United States government taxes capital gains, and in recent years the value of stocks has surged. Once people realize their capital gains by selling stocks that have appreciated in value, those gains are taxable. Capital gains cause problems because realizations, the tax base for gains, are difficult to predict. Moreover, capital gains are not a part of national income and thus accurately predicting GDP growth does not help in predicting revenues from capital gains taxes.

Current budget projections also paint a positive picture for the medium run. CBO's projections show increasing budget surpluses for the next 10 fiscal years, cumulating to 1.5 trillion dollars. Should those surpluses become reality, the American debt to GDP ratio would fall from currently 47 percent to 18 percent in 2008.

However, as any prediction of the future, current budgetary projections face uncertainty:

First, those projections assume current law. Under current law the discretionary caps restrict spending growth and as a result spending is expected to grow at a slower pace than the economy. Also, paying down the debt as implied by current law would lead to a substantial reduction in government spending on interest payments.

Second, the projections assume that ratio of tax revenues to GDP will stay at the high 1997 level.

Third, the projections assume that GDP grows at the same rate as potential GDP in the long run. Thus