Spending the Federal Budget Surplus: An Exercise in Wishful Thinking

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What is this silver liningwe see on the clouds in our crystal ball? Could it be a budget surplus? The last time the U.S. Federal budget showed a surplus was in the first year of the Nixon Administration. Needless to say, pundits and politicians are falling all over themselves to figure out how to spend it.

Before we get too excited about the surplus (which will be pretty small anyway), perhaps we should stand back and consider exactly what we are talking about. The surplus, or deficit (to use a more familiar word) is what's left over after Uncle Sam totals up the revenue from income and payroll taxes and various other sources and subtracts all the spending for defense, Medicare, special prosecutors and other odds and ends. If the Federal government spends more than it takes in, as has been its habit, there is a deficit. More revenues than spending, a surplus.

If we add up the totals of deficits and surpluses since we passed the Constitution in 1787, we should get a number roughly equal to the national debt, now something in excess of $5 trillion dollars. A deficit means the government has to borrow to pay its bills, adding to the national debt. A surplus means something left over, which can reduce the national debt by redeeming some of those trillions of dollars of outstanding Treasury bills, notes and bonds. Deficits started rising in the early 1980s and peaked at close to $300 billion before beginning to fall in the early 1990s.

A surplus in which budget?

One last complication is that there is not one federal budget to be balanced, or in surplus or deficit, but two. One is the unified budget, which includes the regular budget-- defense, Medicare, and special prosecutors--plus Social Security and the Postal Service. The unified budget made its debut in the 1960s on the advice of economists, because it was the best measure of the total impact of government on the economy. However, Social Security (as well as the Postal Service) are technically not part of the budget. The Postal Service is supposed to be self-supporting, and Social Security is supposed to be a trust fund with separate accounting for its revenues (payroll taxes plus interest on its accumulated investments) and expenditures (payments to beneficiaries and operating expenses). It's the unified budget that stands on the verge of crossing over from deficit ($22 billion in the fiscal year ending September 30, 1997) to some modest surpluses ($8 to $10 billion in the next few years, growing larger after 2001). The budget excluding Social Security and the Postal Service will still be in deficit, although that deficit too is shrinking, down around $100 billion from a high of some $400 billion just six or seven years ago.

When the regular budget is in deficit, part of the deficit is financed by selling bonds to the public, and part of it is financed by selling bonds to the Social Security Trust Fund. The Social Security Trust Fund is not currently allowed to invest in anything other than Treasury bonds, although there are proposals afoot to change that rule. Any surplus of revenues over expenditures in the Social Security Trust Fund, therefore, must be invested in Treasury bonds. If there is a deficit in the regular budget, Social Security funds help to finance the deficit. If there were a surplus in the regular budget (which has not occurred in quite some time), the Treasury would have to redeem some bonds from the general public in order to have some bonds to sell to the Social Security Trust Fund.

Where did the "surplus" come from?

The projected surplus in the unified budget is the result of some good decisions and some fortunate economic circumstances. The 1993 budget agreement raised some taxes and put a lid on discretionary spending for both defense and non-defense purposes. (Discretionary spending is the part of total spending that Congress can change easily from year to year, which is about 1/3 of the budget. The other 2/3 is mandatory spending, including Social Security, Medicare, Medicaid, other entitlements, and interest on the national debt.) That agreement came at a time when interest rates were falling and the economy was taking off into what proved to be a sustained and vigorous expansion. As the economy grew, revenues grew sharply while spending grew very slowly. Lower interest rates helped to hold down the growth of that part of the budget that went to interest payments (which had risen from 7% of the budget in 1980 to 15% in recent years).

What should we do with the surplus?

Now we come to the fun part. How should we deal with this windfall? In broad terms, there are only three choices. We can reduce the debt, cut taxes, or increase spending, or some combination of the three.

Before we get to excited over winning the collective lottery, a few words of caution. First, the initial surpluses are quite small. Ten billion dollars or so may mean a lot to your household or mine, but relative to a budget of $1.7 trillion itÕs a drop in the bucket. Second, the projected surpluses depend crucially on assumptions about continued growth of income and employment and continued low inflation and interest rates. This expansion is six years old, and a recession in the next five years is not out of the question, especially with the current crisis in Southeast Asia that is likely to impact the United States sooner or later in the form of declining export sales and/or competition from much cheaper imports. For both of these reasons, Congress and the President should approach spending the surplus with caution. They might learn from some states that have also experienced budget surpluses. In a few states, if revenues exceed projections so that there is money left over at the end of the fiscal year, those excess revenues become a one-time tax cut redistributed to citizens, most often as income tax refunds. No surplus, no tax cut.

Thus, the tax cut doesn't get built into future budgets when the revenue might not be there to support it.

Paying down the debt

At least some politicians would like to use the surplus to pay down the public debt. This option is the least glamorous and exciting, but it might not be a bad idea. If the government redeems some of its debt, those funds will then become available for other capital investments, holding down interest rates. Lower interest rates benefit not only homeowners and business investment but also the government budget. The interest expense in the federal budget would fall both because of less debt to pay interest on and because of lower interest rates as the government rolls over its remaining debt.

Some people have a notion that reducing the national debt will help strengthen Social Security. Any such effect is largely indirect. To the extent that the government has less debt, when Social Security has to cash in some of its accumulated IOUs to pay benefits, the government will find it easier to borrow. So reducing indebtedness now may give the government more resources in the future. But right now, if the surplus were used to redeem government IOUs held by the Social Security Trust Funds, what would the trustees do? They are not authorized to invest in anything but Treasury securities, and it makes no sense to hold cash which earns little or no interest.

Tax cuts?

Tax cuts are a politically popular but dangerous use of surplus funds. Certainly the tax code can always stand some improvements, so some modest tinkering with small revenue losses might be justified. But because taxes are easy to cut and hard to raise, any tax cuts financed out of the surplus would be committing the government to lower revenues in the future when spending demands might be higher. In addition, contrary to popular opinion, Americans are not really heavily taxed. The current tax burden (Federal, state and local combined) in the United States is about the same as in Japan and considerably lower than in Candada, Italy, France, Germany, or Great Britain--about 32% of GDP. And it has not changed very dramatically over the decades. The government share was 29% in 1970, 34% in 1980, 30% in 1990.

Discretionary spending

The third option is to consider whether some spending increases might be justified. About 15% of spending goes for defense, down from 21% in 1990. Some would argue that this is enough when there is no major single enemy as there was during the Cold War, while others argue that we have cut military preparedness to a dangerously low level. Another 15% covers all of discretionary spending outside the military. If there are any spending increases, this is the area that offers the most candidates. Both defense and nondefense discretionary spending have been on a tight rein since the 1993 budget agreement and even before.

Any discretionary spending increases out of projected surpluses should meet two tests;

1. The spending should offer a plausible justification of being an investment, one that will increase human or physical capital in such a way as to increase future productivity in either the public or the private sector.

2. To the extent possible the spending should be non-recurring, so that it will not automatically appear again in the next year's budget.

What kinds of spending might meet those two tests? Quite a lot. Let me suggest a few possibilities.

Deferred maintenance

Bridges, roads, dams, facilities at national parks have all the victims of tight budgets. Maintenance can be deferred up to a point, but at a cost. It is usually cheaper to fix earlier than latet. The U.S. has an enormous backlog of deferred maintenance that can be chipped away at when the budget picture is rosiest.

Administration.

Least glamorous of all categories of spending, administration has some one-time unmet needs. Social Security needs a computer system for the twenty-first century. So does the much maligned IRS if it is going to continue to find the money to run the government and to assure the honest taxpayers that it is diligently pursuing the dishonest ones. These expenditures could be spread over several years, but don't have to become a permanent part of the budget.

Welfare transition costs

Governor Thompson of Wisconsin tells us that we can get people from welfare to work, but it isn't cheap. These folks need job skills, retraining, day care and transportation to help them over the hump. The long run payoff is productive, taxpaying workers, but we have to make the investment in the interim. The same is true of rehabilitating prisoners and drug and alcohol addicts. All of these are investments in human capital with potentially huge human and financial payoffs.

The prospect of a budget surplus is a novel and exciting challenge for Americans and a test of the nation's political leadership. It may be a transient opportunity that is soon swamped by a recession, natural disasters, or an upsurge in the cost of Medicare and Medicaid. But while we have the opportunity to rethink our priorities and decide what really matters, we should make the most of it.

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