MANAGING ANTICIPATED BUDGET SURPLUSES

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Abstract

Any policy decision regarding the use of the anticipated budget surplus should recognize that the eventual disposition needs to follow the same criteria for good fiscal policy as any other fiscal decision. Good policy should take into consideration the current high level of federal spending, the existing burden on the taxpayer, and, for expenditures, whether they are programs which complement the private sector or merely substitute government spending for a more efficient private activity.

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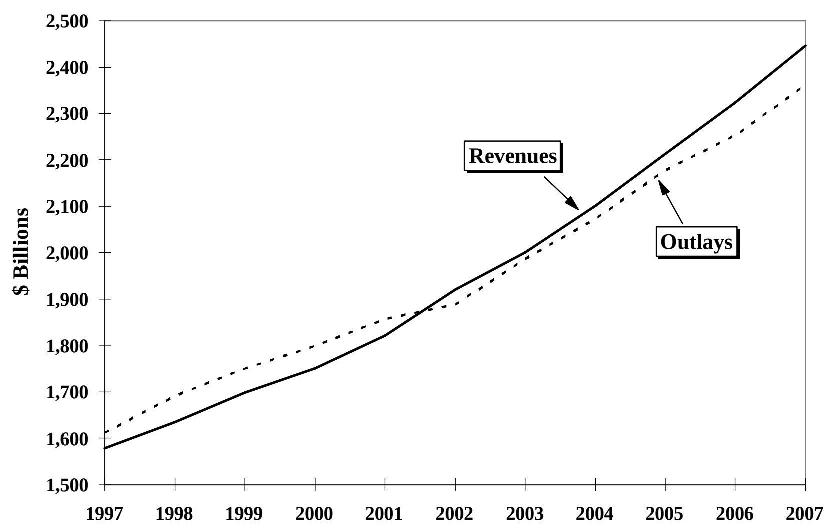
INTRODUCTION

For the first time in nearly three decades, there is the possibility of a surplus in the budget of the Federal Government.[1] The current economic expansion in the United States is well into its seventh year, and there is no reason to expect this expansion to terminate any time soon. The fertile ground for this sustained economic growth has been produced, in large part, by the anti-inflationary policies of the nation's central bank, the Federal Reserve. The moderate growth in aggregate demand, a positive feature of this expansion, will preclude the need for large increases in interest rates which could suddenly choke off the current recovery.

As a result of this expansion, revenues to the federal treasury will provide a significant diminution in the deficit. Combined with some discipline in spending, these additional revenues may offer policy makers a chance to deal with a surplus. The possible alternative uses are increased programmatic spending, reduction in taxes, and retirement of the federal debt. This paper reviews the economic consequences and likely public policy scenarios related to the use of a surplus for these three alternatives.

Budget Outlook Through 2007



Source: Congressional Budget Office, September 1997.

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[1] Congressional Budget Office, *The Economic and Budget Outlook*, September 1997, p. 27.

ANALYSIS OF FISCAL ALTERNATIVES

The macroeconomic results of alternative uses of any surplus are relatively straightforward, but their viability in the policy-making process is an important consideration when conducting a realistic analysis of sustainable options. Each of the three options–increased spending, tax reductions, and debt retirement–would have a different effect on economic growth, but a realistic analysis would also look at the policy record and the incentives which drive the eventual formulation of fiscal policies. These three options are only relevant if they can withstand the political tests that are inherent in the development of policy.

The record of the past 50 years demonstrates the ability of special interests to dominate the fiscal process. In part, this is because the federal budget has grown to such large proportions that the public's understanding of the specifics of fiscal policy has diminished. Since a representative democracy relies on the efforts of the representatives to understand the details of the policy process, the public's understanding of the policy or the process is usually not comprehensive. More programs, run by a larger bureaucracy, create an even greater ignorance of how revenues are allocated.[2] The beneficiaries of this complexity and ignorance are the organized special interests who seek favored treatment. Economic theory tells us that special interests have an incentive to organize in order to promote the delivery of benefits to themselves. Success for the small groups only requires that they overcome the cost of organizing to lobby the government. They ask the government to impose small per capita costs on a larger, less organized group in order to pay for the provision of larger per capita benefits to themselves. The small size of the group is advantageous in reducing the cost of organizing. Unorganized groups like taxpayers typically do not have the ability to commit resources to discovering what policies are being developed, but the special interests find the taxpayers to be a particularly good target for wealth reallocation policies.

In light of these realities, a discussion of the various options presented by a budget surplus follows.

Increased Programmatic Spending

Increased programmatic spending is the most likely use of the surplus, but the nature of the expenditure is the key to predicting its economic effects, and the record of government spending in recent years does not bode well for achieving any growth stimulus from new spending. There are, of course, requirements which the Federal Government should meet in order to promote healthy economic growth: spending on national defense; defining and enforcing property rights which allow a market economy to function; providing physical infrastructure such as roads and bridges; and maintaining public safety and public health. Up to a point, careful expenditure of federal revenues for such services not provided by the private sector establishes the institutional

[2] It is not economically rational for the typical citizen to try to understand all of the complex workings of government, its policies, or their results. The cost of doing so would far outweigh the individual benefits derived.

framework that encourages work, saving, investment, invention, and innovation, the foundation of a growing economy, after which more spending would be counterproductive. The current level of federal spending provides sufficient room for providing these helpful services, if priorities were rearranged to accommodate them.

A look at the recent spending record leads to the conclusion that a large portion of federal expenditure is not directed at such helpful complements to private sector efforts. Instead, a significant portion of federal spending is directed to programs that are essentially government substitutes for services already provided by the market economy, usually at greater cost than the private alternative. Increased availability of revenues historically has induced the Federal Government to spend the new budgetary resources on unproductive programs. One study, which looked at spending following increases in revenue from 1947 to 1990, showed that spending for transfer payments and other redistributional programs increased by $1.97 for each $1.00 in tax revenue increase.[3]

The growth of government beyond some point leads to the expenditure of greater revenues on special-interest programs. For example, several studies indicate that the size of government has long passed the point desirable for efficient growth. One study suggests that the optimal size of government is about 17 percent of gross domestic product (GDP), about four percentage points less than the current level.[4] Another study estimates the best level of the total of federal, state, and local spending to be in the 21.5 to 22.9 percent range, which is at least 7.5 percent of GDP less than the present level.[5] The deadweight burden of government increases as various interest groups expend resources, including the taxpayers', while competing for unproductive redistributional opportunities rather than committing these resources to productive activities. Thus, while spending increases could make a positive contribution to economic growth, the record indicates that such positive initiatives face heavy competition from special-interest spending demands.

Just as the highly organized special-interest groups have been in a position to take advantage of increased tax revenues (or deficit spending) in the past, the special interests will be first in line to find their own uses for any surplus, claiming them early in the budget process. This implies that spending initiatives may not necessarily produce a better overall climate for economic growth. The result is often an addition to the already massive government cross-subsidization throughout the economy which discourages the initiative required for growth.

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[3] Richard Vedder, Lowell Gallaway, and Christopher Frenze, *Taxes and Deficits: New Evidence*, Joint Economic Committee, October 1991.

[4] Lowell Gallaway and Richard Vedder, *The Impact of the Welfare State on the American Economy*, Joint Economic Committee, 1995.

[5] Gerald W. Scully, *What Is the Optimal Size of Government in the United States?*, National Center for Policy Analysis, November 1994.

Tax Reduction

Elimination of budget surpluses through reduction in taxes has the advantage of returning resources to the hands of the private sector. From an economic perspective, this option reduces the deadweight burden of government and encourages work, saving, investment, and innovation. Probably the most constructive option for reducing taxes is a broad-based reduction, rather than one focused on a particular industry or program–the record demonstrates that the government typically does not guess well in selecting winners in the marketplace. For example, a tax incentive to spur savings for all workers would have the dual benefit of increasing the amount of money available for investment as well as encouraging work and investment through changes in the effective marginal tax burden.

As any tax reduction proposal or current law is subjected to the policy process, however, it will be the active political support which determines its long-term viability. A broad-based reduction, such as cuts in marginal tax rates or savings incentives, might be the most useful reduction from an economic growth perspective. Reductions which reduce biases in the tax system against capital formation also would be economically healthy. The more general and broad-based such tax incentives are, the more likely that long-term economic growth will be improved. On the other hand, a policy of narrowly focused benefits would likely be channeled to the advantage of well-positioned special-interest groups with little or no positive effect on economic growth.

Debt Retirement

The last option, debt retirement, can be an attractive policy to many observers. Since interest payments on the federal debt are now equal to 15 percent of federal expenditures, reduction of the debt would provide some relief from the fiscal burden of government. In fact, without further changes in the law, the current policy for the use of any surplus is debt reduction. As maturing government debt instruments are refinanced, lesser amounts of new debt are required because the surplus is used to pay off the difference. Compared to using the funds for consumption spending, returning them to the capital markets through debt retirement would stimulate the economy, since the level of government spending is already beyond optimal levels. Just as borrowing the funds for consumption spending reduces the growth potential of the nation's economy, returning these funds would provide resources for investment and increase opportunities for growth. Yet, as some observers have noted, use of a potential surplus for debt retirement would deny any opportunity for tax reform to correct biases in the tax code against capital growth.

Creating an organized special-interest constituency for debt retirement would be difficult.[6] As with the borrowing of funds from the capital markets, the impact of the return of these funds will

[6] Investors in U.S. securities are not beneficiaries of a windfall like programmatic or tax break beneficiaries and, therefore, have no special interest in advocating one particular use of surplus budget amounts.

produce little in the way of discernable changes in interest rates or international exchange rates. Due to more significant movements in these prices in response to other variables, the effects of borrowing or debt retirement are lost to any measurement in capital markets. Despite the positive effect of the debt retirement, the inability to measure price changes in the capital markets makes the option politically less attractive, just as the inability to see the price of a capital rise in response to borrowing makes the debt financing of consumption spending more attractive.

The problem with debt retirement as a likely policy outcome is that there is no organized constituency to support the continued use of any surplus as a means of debt retirement. Even if a debt retirement policy were formally adopted, the chances are small that the amount dedicated to this purpose would remain available for any significant period under pressure from organized special-interest groups. In fact, anticipated surpluses would almost never be realized in the face of special-interest pressure. Only unanticipated surpluses would be actualized, their unexpected nature providing them a chance of survival.

CONCLUSION

Regardless of the specific policy-making mood prevailing at the time possible budget surpluses are being committed, good policy for promoting economic growth would benefit from the observance of a few rules:

- Avoid narrowly focused expenditures or tax reductions that require the government to select winners in the marketplace. For example, broad-based tax reduction is superior to narrow tax cuts targeted to special-interest groups.

- Evaluate the alternative uses of the surplus according to their effects on long-term economic growth. Thus, their impact on work, saving, investment, invention, and innovation should be considered.

- Test spending proposals to ensure they are providing public goods that are not supplied by the private sector rather than substituting government programs for existing, more efficient private-sector initiatives. Tax reduction should be geared to improving broad incentives for optimal economic growth.

This type of strategy will produce a stronger economy and result in less waste than a strategy based on an unsubstantiated bias toward either spending, tax reduction, or debt retirement options.

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