

BUDGET SURPLUSES, DEFICITS AND GOVERNMENT SPENDING

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EXECUTIVE SUMMARY

The emergence of a budget surplus raises several questions: is federal fiscal behavior impacted when government revenues exceed outlays? Do surpluses one year induce spending the next year? Historically, have surpluses ever led to tax reduction? Debt reduction?

Applying econometric analysis to federal budgetary data extending back to the George Washington administration but emphasizing the post-war era, the authors conclude:

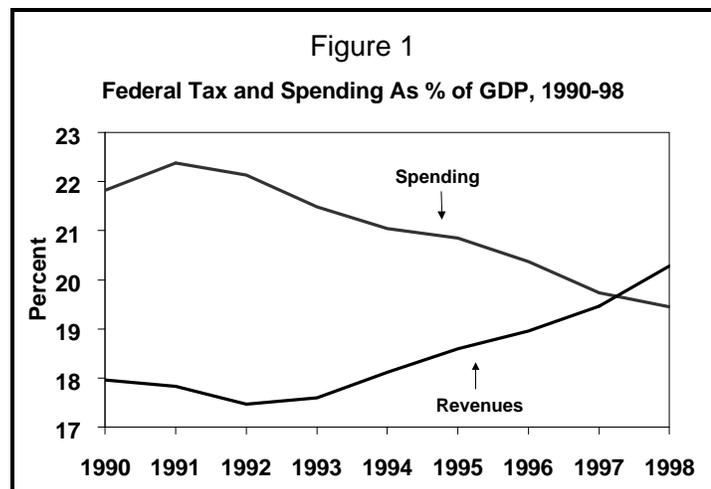
- Over the full sweep of constitutional history, on average 37 cents of each one dollar surplus were used for increased federal spending in the following year;
- The propensity to spend out of budget surpluses has risen significantly over time, and in the postwar era at least 60 cents of each surplus dollar were spent the next year;
- Early in the Republic, a majority of surpluses were returned to taxpayers in the form of lower taxes; in the modern era, very little if any of surplus funds were used for tax reduction;
- Likewise, the persistence of surpluses has declined; before 1930, on three occasions surpluses lasted 10 or more consecutive years; more than 40 years has past since the last back-to-back surpluses; consequently, only a small portion of surpluses in the modern era typically goes for debt reduction;
- Surpluses arising right after World War II, in the mid-1950s, and in 1969 were quickly dissipated by major spending increases;
- If Social Security is excluded from the budget, the same major finding holds: budget surpluses one year induce government spending that absorbs most of that surplus during the following year;
- There is a negative relationship between federal spending as a percent of total output and economic growth; if surpluses typically induce higher spending, one economic growth strategy would be to reduce those surpluses through revenue-reducing tax reform.

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INTRODUCTION

In recent years, as federal budget deficits have narrowed and even disappeared (if one includes Social Security in the budget accounting), there have been numerous proposals to deal with prospective budget surpluses. In this paper, we examine the historical experience. When the federal government's fiscal condition improves, how does that impact on fiscal behavior? In particular, do budget surpluses induce increases in federal spending? Or, do they induce reductions in tax burdens? Or, some combination of these and even other possibilities, e.g., reducing the national debt?

As Figure 1 shows, federal tax revenues have risen as a percent of total output (gross domestic product (GDP)) in recent years, while federal spending has decreased relative to GDP. The effect of that has been to eliminate the budget deficit, defined as including Social Security. Budget surpluses are such a rarity that many adults cannot remember the last one before this year (which occurred in 1969). In the 52 fiscal years since the end of World War II, only on nine occasions has the federal government run budget surpluses (only seven years if Social Security is excluded from the budget). Over the entire history of the Republic, however, budget surpluses actually outnumber budget deficits (108 to 100), with surpluses dominating in a large majority of the years prior to 1930.



When surpluses occur in modern times, they tend to be short-lived. Only once since World War II, in 1947 through 1949, did the federal government have three consecutive budget surpluses.¹ The only other postwar back-to-back surpluses came in 1956 and 1957. By contrast, before the Keynesian Revolution of the 1930s, on three occasions the U.S. ran 10 or more years of consecutive budget surpluses: 1825-1836 (12 years); 1866-1893 (28 years), and 1920-1930 (11 years).

¹ Even that claim is disputable, since if Social Security is kept apart from the federal budget, in 1949 the budget was slightly in deficit.

Interestingly, the string of 28 consecutive deficits that ended in fiscal year 1997 came almost precisely one century after an era of budget surpluses of precisely the same duration.

What Do You Do With A Budget Surplus? What Is a “Budget Surplus?”

If the Nation in a given year has a budget surplus, in the following year it can:

- 1) Increase government spending sufficiently to end the surplus;
- 2) Reduce taxes (or, theoretically, non-tax receipts) sufficiently to end the surplus;
- 3) Not dramatically change taxes and spending, maintaining the surplus to reduce the national debt; or
- 4) Some combination of the three options above.

It should be pointed out that “surplus” here and in common usage means when the cash revenues received by the federal government in a given time period exceeds the cash outlays in that same time period. This cash method of accounting gives an excellent indicator of the current impact of the federal government on the allocation of resources and of the strains it places on financial markets. For example, when the federal government has a deficit using cash accounting of, say, \$200 billion, it implies that government-induced demand for loanable funds will be high, with attendant effects on financial markets (e.g., probable higher interest rates) and on the ability of the private sector to borrow.

The cash accounting approach used does not, however, provide for future liabilities of the government that may accrue in the given time period. The use of an accrual basis of accounting, common in the private sector, is not followed. In a given year, the government could have a budget surplus using cash accounting, but a budget deficit using accrual methods that count as expenses (outlays) in this time period newly created liabilities of the government that will be funded in future years (e.g., increased pension obligations for federal government workers). Because Social Security was designed to be an insurance program where some current period cash obligations are incurred in order to meet cash expenditures for pension payments in a future time period, there is a strong argument for removing Social Security completely from the federal government’s cash accounting system. We return to that point later. For the moment, however, we follow conventional practice in defining “surpluses” based on all cash receipts and outlays of the federal government.

There are other accounting issues as well, although data limitations prevent us from addressing them fully. Some would argue, for reasons similar to those used for Social Security, that capital expenditures should be handled in a separate budget (perhaps with non-cash depreciation liabilities included in the current budget). Professor Robert Eisner favors defining budget surplus or deficit in terms of the change in the real value of the federal debt.² There is the issue of the accounting of implicit subsidies given to government sponsored enterprises such as Fannie Mae and Freddie Mac

² Robert Eisner, *How Real Is the Federal Deficit?* (New York: Fress Press, 1986).

that are, strictly speaking, private organizations.³ In general, newly occurring contingent liabilities associated with loan or deposit guarantees are not counted as outlays, the importance of which was revealed in the savings and loan crisis of the 1980s. One might even argue that the changing market value of government held assets (e.g., gold at Fort Knox or at the New York Federal Reserve) should be taken into account in assessing the financial picture of the federal government. A detailed analysis of budget surpluses and deficits using alternative accounting concepts is virtually impossible given data limitations and is, in any case, beyond the scope of this study.

The Impact of Budget Surpluses and Deficits on Federal Spending: Evidence

Budget data are available for the federal government from the first term of the George Washington Administration to the present. Because the value of the dollar has changed over time because of inflation and also because the economy has grown enormously in real terms, a given size deficit or surplus meant much more in, say, 1800 than it does today. In order to account for these changes in prices and output, we will relate budget outlays, receipts, and surpluses (or deficits) to the size of the national output (gross national or gross domestic product) in the given year.⁴

Using ordinary least squares regression analysis, we regressed the change in federal government spending as a percent of total output against the government budget surplus (or deficit) as a percent of total output lagged one year. Thus it is hypothesized that if the federal government had, say, a \$10 billion budget surplus in one year (1998), that it might induce some increase in spending in the following year (1999).

Federal government spending can change, of course, for reasons unrelated to its immediate cash accounting situation, and ideally we would like to control for those other factors in analyzing the surplus-spending relationship. While data limitations are severe, we did identify two such measurable control variables. The first is a dummy variable denoting years in which the United States was engaged in a significant war. There have been eight such wars since the beginning of constitutional government: the War of 1812, the Mexican War, the Civil War, the Spanish-American War, World War I, World War II, the Korean War, and the Vietnam War.

³ For an old but still relevant discussion of some of the issues relating to government sponsored enterprises, see Richard Vedder, *The Federal Underground Economy*, Study, Joint Economic Committee, United States Congress (Washington, D.C.: Government Printing Office, 1982).

⁴ Budget data prior to 1940 were taken from U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1975); for more recent years, data came from the 1998 *Economic Report of the President* (Washington, D.C.: Government Printing Office, 1998) or, for 1998, from the U.S. Treasury web site. Output data for 1791-1888 are gross national product estimates from Thomas Senior Berry, *Production and Population Since 1789: Revised GNP Series in Constant Dollars* (Richmond, VA: Bostwick Press, 1988). For 1889-1928, the official Kuznets estimates are used from *Historical Statistics...* For 1929-97, gross domestic product (GDP) statistics were obtained from the U.S. Bureau of Census web site; 1998 is estimated using an average of the currently reported numbers for the second and third quarter.

Also, the propensity to spend budget surpluses may depend on the debt situation of the government. If the national debt (the accumulated total of past budget deficits) is high in relation to national output, the propensity to spend out of surpluses might be less than if the national debt is historically low in relation to output. When debt is high, there may be a greater sense of political and financial urgency to reduce that debt burden by running budget surpluses persistently. As Figure 2 shows, the debt burden has varied enormously over time.

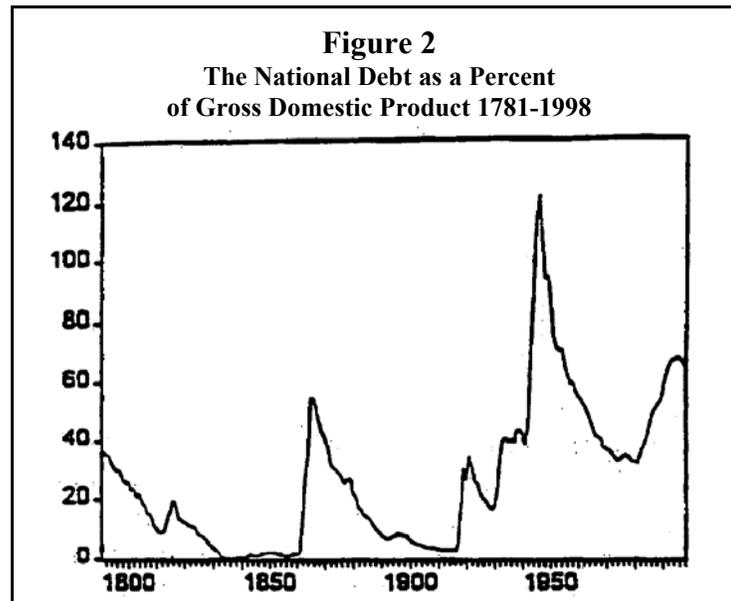
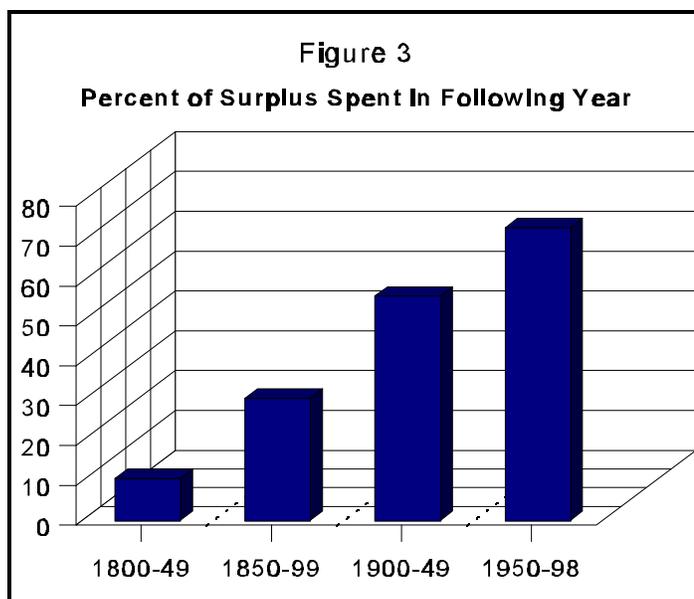


Table 1 shows the results of our analysis for five broad time periods: 1792-1998 (207 years), the first half of the 19th century (1800-

Table 1. Regression Results: Surplus-Spending Relationship, 1792-1998:					
Dependent Variable: Change in Federal Spending As % of Total Output*					
Variable or Statistic	1792-1998	1800-49	1850-99	1900-49	1950-98
Constant	0.39 (1.03)	0.073 (0.41)	0.103 (0.22)	1.37 (1.14)	9.424 (2.72)
Federal Surplus, % of GNP, previous year	0.373 (4.82)	0.105 (1.17)	0.307 (2.7)	0.563 (3.32)	0.735 (5.81)
National Debt as % of GNP, previous year	-0.016 (1.49)	-0.02 (1.39)	-0.034 (1.74)	-0.039 (1.33)	-0.164 (2.2)
Wars Dummy War = 1, no war = 0	3.794 (5.8)	0.532 (1.31)	5.699 (4.92)	10.583 (4.98)	-0.477 (0.81)
R2	0.262	0.171	0.484	0.504	0.328
D-W Statistic	1.92	1.94	1.91	1.94	1.99
ARIMA terms	(0,1)	(1,0)	(1,0)	(1,0)	(1,1)
F-Statistic	17.94	2.33	10.59	11.42	4.21
* Numbers in parentheses are t-values.					
SOURCE: Regression equations; see text.					

1849), the second half of that century (1850-99), the first half of the 20th century (1900-49), and the last half of this century (except for 1999).⁵ Turning first to the complete sweep of history, and controlling for wars and the relative size of the national debt, we find that a one dollar surplus in a given year is associated with a 37 cent increase in government spending in the following year, with the result being statistically significant at the 1 percent level. In other words, on average throughout American history, the government has spent somewhat more than one-third of its surplus quickly (the year following the surplus).

The propensity to spend out of surpluses has risen sharply and continuously over time (see Figure 3). In the first half of the 19th century, the observed relationship between budget surpluses and government expenditure is not statistically significant, and even if it were, the indications are that only about a dime of each dollar of surplus was spent in the year following the generation of the surplus. The propensity to spend out of surpluses rose in the last half of the 19th century, but even then only a little over 30 cents of each dollar was spent in the year following a surplus. By the 20th century, things changed markedly, with a majority of surpluses being dissipated in spending almost immediately, with that tendency greater in the last half of the century compared with the first half (73.5 cents of each surplus dollar being spent vs. “only” 56.3 cents).



More Detailed Analysis for the Postwar Era

Better economic data are available for the modern era, allowing us to control for other factors that might impact on the propensity to spend out of surpluses. In particular, in the age since the beginning of the modern welfare state, some government expenditures occur automatically in response to downturns in business conditions, such as spending on unemployment claims. Indeed, Keynesian economists have long argued that these “automatic stabilizers,” present also on the tax side, contribute to economic stability. Accordingly, we introduce two variables measuring business conditions. The first is the rate of growth in real (inflation adjusted) gross domestic product, and the second is the civilian unemployment rate.

⁵ There are some minor unavoidable data problems associated with this analysis. The budget numbers are for fiscal years, while output data are on a calendar year basis, so the calculation of, say, deficits as a percent of GDP, is very slightly (but consistently) misstated. More generally, the accuracy of the output statistics for the early years is necessarily somewhat suspect. Also, on several occasions, the definition of the fiscal year changed. Accordingly, the 1976 “transition quarter” is lost in this accounting.

Finally, we are able to offer an alternative measure of the existing debt. In the results reported in Table 1, the national debt was measured using the gross debt figure that includes all federal obligations. Yet some of those obligations are held by government agencies, such as the Social Security Trust Fund or the Federal Reserve System. Accordingly, some persons argue that the appropriate debt measure is the non-federally held national debt. We calculate the surplus-spending relationship using both debt measures.

Table 2. Regression Results: Surplus-Spending Relationship, 1947-1998:Dependent Variable: Change in Federal Spending As % of Total Output*		
Variable or Statistic	Model 1	Model 2
Constant	2.376 (1.49)	2.198 (1.42)
Federal Surplus, % of GDP, previous year	0.577 (7.54)	0.624 (5.52)
% Growth, Real GDP	-0.133 (3.1)	-0.124 (2.79)
Civilian Unemployment Rate	0.232 (1.48)	0.249 (1.53)
Gross National Debt as % of GDP, previous year	-0.041 (3.21)	
Non-Federally Held National Debt as % of GDP, previous year		-0.046 (2.49)
War Dummy (1=war; 0= no war)	-0.555 (1.15)	-0.604 (1.36)
R2	0.784	0.784
D-W Statistic	2.07	1.97
ARIMA terms	(0,1)	(0,1)
F- Statistic	27.25	27.2
*Numbers in parentheses are t-values.		
SOURCE: see text		

Table 2 shows regression results for the period 1947 to 1998 using two alternative measures of the debt. The results show an extremely robust statistical relationship between budgetary status and subsequent spending. A one dollar surplus is associated with an increase in spending in the following year of between 58 and 62 cents, depending on the definition of national debt used as a control variable. Taking an average of the two regressions, we can say that about 60 cents of every dollar of surplus generated in the postwar era is dissipated in the following year as a consequence of an increase in the proportion of national output that is spent by the federal government. Additionally, the results do show that the propensity to spend is muted somewhat when the national debt-to-output ratio is high. Presumably both political and economic pressures during periods of high federal debt do serve to restrain governmental temptation to spend the surplus.

Excluding Social Security from the Budget: Does That Alter the Findings?

As mentioned above, there are strong arguments for excluding Social Security from the budget. Indeed, officially, for several years that spending has been excluded, yet virtually all published reports on federal financing still include the “off budget” items dominated by Social Security. Since the Social Security System has been operating at a surplus in a current period cash accounting sense, the reported deficit or surplus that arises after excluding Social Security is different (see Figure 4 for the historical data relating the deficit to GDP).

Does the conclusion above - that most budget surpluses are utilized to increase government spending - hold if the budget surplus (or deficit) is calculated by excluding Social Security receipts and expenditures from the budget? The short answer is

“yes.” Table 3 replicates Table 2, except that the definition of budget surpluses and government spending have been altered to exclude Social Security. The results suggest that 63 or 64 cents of each dollar of surplus in one year is utilized to finance enhanced spending (as a percent of GDP) in the following year. If anything, the results are slightly stronger in supporting the hypothesis that in the modern era, surpluses induce subsequent spending increases.

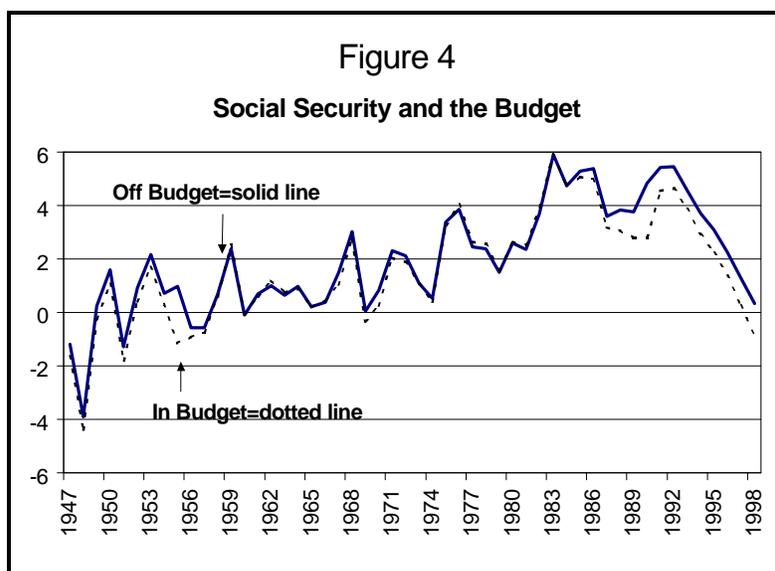


Table 3. Results: Surplus-Deficit Relationship, Social Security Off-Budget: Dependent Variable: Change in Federal Spending As % of Total Output*		
Variable or Statistics	Model 1	Model 2
Constant	1.692 (0.89)	1.872 (1.03)
Federal Surplus, % of GDP, previous year	0.631 (5.42)	0.637 (5.47)
% Growth, Real GDP	-0.111 (1.94)	-0.111 (1.95)
Civilian Unemployment Rate	0.276 (1.48)	0.261 (1.4)
Gross National Debt as % of GDP, previous year	-0.027 (1.38)	
Non-Federally Held National Debt as % of GDP, previous year		-0.036 (1.61)
War Dummy (1=war; 0= no war)	-0.597 (1.11)	-0.593 (1.12)
R2	0.739	0.742
D-W Statistic	2.16	2.14
ARIMA terms	(0,2)	(0,2)
F-Statistic	17.75	18.11
*Numbers in parentheses are t-values. SOURCE: See text.		

*Lagged
Effects of Budget Surpluses*

Spending

The findings above assume that the spending impact of budget surpluses occur in the first budget year following the surplus. It is possible that there could be additional spending effects in subsequent years. Accordingly, we did some statistical estimation where we related the Nation's fiscal condition to spending changes one, two and even three years in the future. The results for 1947-98 for the conventionally measured budget numbers (including Social Security spending and receipts) suggest that the overwhelming impact occurs almost immediately. The relationship between budget surpluses and spending two or three years later is positive but not significant in a statistical sense. Using the model with gross national debt as a control variable, a dollar of surplus this year leads to 67 cents of

spending over the next three years, with 85 percent of that increase occurring in the first year (56 cents). Using the alternative debt measure, spending rises 70 cents in the first three years for each dollar of surplus generated, again with 85 percent of that increase occurring in the first year (60 cents). Again, the out-year spending increases are not statistically significant.

THE IMPACT OF BUDGET SURPLUSES ON TAXES AND DEBT: SOME EVIDENCE

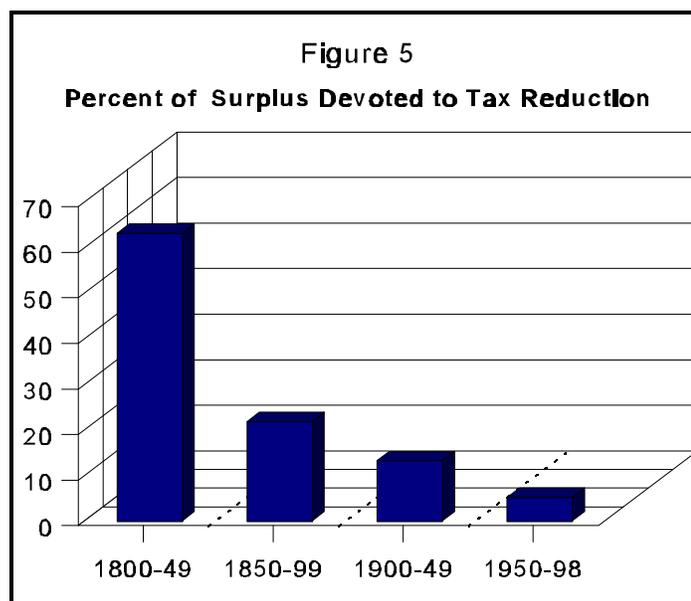
As indicated earlier, budget surpluses can be used to finance more government spending, but they also can be used to finance tax or debt reductions. Turning first to taxes, have surpluses historically been used to reduce tax burdens?

We repeat much of the analysis above, but instead of estimating regression equations designed to explain changes in federal spending, we look at changes in the federal tax burden, which is defined here as federal tax (or other) revenues as a percent of total output. In Table 4, we look at long-term historical data as before, including control variables for wartime years and for the gross national debt

Variable or Statistic	1792-1998	1800-49	1850-99	1900-49	1950-98
Constant	0.087 (-0.76)	0.166 (0.91)	0.137 (-1.14)	0.284 (0.98)	-0.341 (1.30)
Federal Surplus, % of GNP, previous year	-0.145 (-7.12)	- 0.633 (-4.24)	- 0.218 (-11.57)	- 0.132 (2.98)	-0.052 (1.46)
National Debt as % of GNP, previous year	-0.008 (2.59)	0.011 (0.78)	-0.013 (2.71)	-0.020 (2.52)	0.005 (1.30)
Wars Dummy War =1, no war = 0	0.302 (-1.42)	-1.379 (2.57)	-0.24 (1.14)	0.954 (1.57)	0.195 (1.01)
R2	0.275	0.411	0.792	0.46	0.358
D-W Statistic	2.05	2.05	1.92	2.11	2.00
ARIMA terms	(0,1)	(1,0)	(1,0)	(1,1)	(1,2)
F-Statistic	19.15	7.86	42.82	7.5	3.90

* Numbers in parentheses are t-values.
SOURCE: Regression equations; see text.

burden as a percent of total output (GNP or GDP). Over the entire expanse from 1792 to 1998, each dollar of surplus is estimated on average to have generated 14 cents in tax reduction in the following year, with the result being statistically significant at the 1 percent level. Note that the estimated long-term spending effects (37 cents) discussed above are far greater than the tax effects (14 cents). Disaggregating the data by time periods (Figure 5), we see that in the early 19th century, a large proportion (63 cents) of each surplus dollar was returned to the taxpayer in the form of reduced taxes.⁶ That proportion fell sharply over time, although still was both quantitatively and statistically significant in the late 19th century. In the last half century, only about a nickel of each dollar of surplus was returned to taxpayers in the form of reduced tax burdens, and even that result is not statistically significant (we cannot be confident that there was *any* tax reduction).



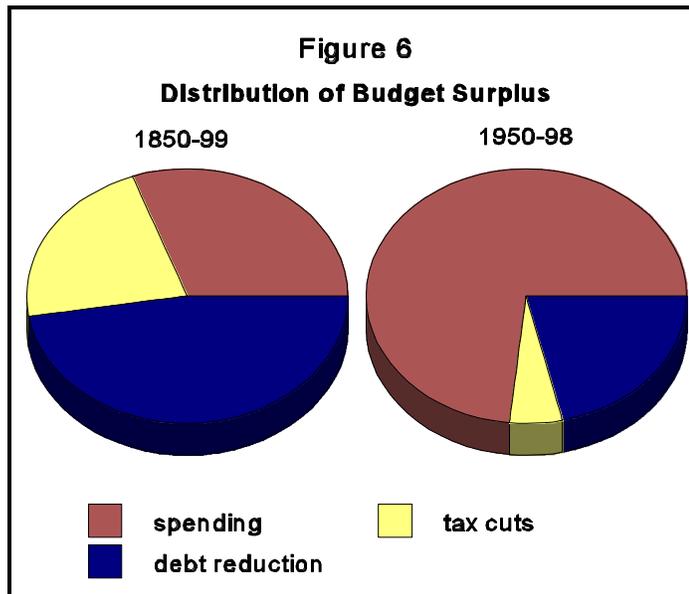
A similar finding is observed for the postwar period (1947-98) using additional control variables for business cycle movements. Again, only five cents of every dollar of surplus is estimated to be used in the following year for tax reduction, with the result not statistically significant at the five percent level.

We have estimated the marginal impact of a dollar of budget surplus on spending increases and tax reduction. By inference, any amount left out of that dollar is used for debt reduction (continued budget surpluses). Looking at our results by half-century, the results imply that 26 cents of each dollar was used for debt reduction in the early 19th century, 48 cents in the latter part of that century, and 31 cents in the first half of this century. For the years since 1950, only 21 cents of each dollar has gone for debt reduction, the lowest proportion observed. The portion of surpluses used for tax reduction may be overstated in the early 19th century given the importance of non-tax revenues, so it appears to us that perhaps the best historical comparison over time is to compare the late 19th with the late 20th centuries (see Figure 6). In the late 19th century, 30 cents of each surplus dollar went for spending enhancement, compared with 73 cents in the current period. A century ago, 22 cents of each surplus dollar went for tax reduction, compared with, at best, five cents today. A century

⁶This may be significantly misstated because of the nature of early federal government revenues. The assumption here is that government revenues and tax receipts are equal, which is approximately true for the modern era. In the early 19th century, the federal government derived significant receipts in some years from land sales. Taxation, moreover, was largely in the form of custom duties, not direct levies on the population.

ago, nearly half (48 percent) of surpluses went for continued debt reduction, compared with only a little over 21 percent today.

Why these changes? We suspect it is because the political environment in which budget policy is formulated has changed. The marginal political benefits from government spending have risen with the emergence of interest group politics. The Keynesian Revolution has provided an intellectual rationale for downplaying the importance of debt reduction. The same special interest groups that promote expenditure enhancement often work to prevent tax reduction, thereby lowering the marginal political benefits over time of tax cuts.⁷ In general in the postwar era, rising tax burdens have been accompanied by even greater increases in government spending, leading to greater deficit spending.⁸ Tax increases impose political costs that are offset by enhanced spending.



SOME CASE STUDIES

The 1969-70 Experience

The statistical results above, while strong and compelling, do not fully convey the flavor of the experience involved in responding to budget surplus situations. The postwar era provides several case studies to demonstrate that surpluses tend to be followed by significant increases in federal expenditures.

The last budget surplus occurred in 1969. In that year, federal outlays rose slightly over 3 percent, or actually significantly less than the rate of inflation. Indeed, this spending restraint was a factor in explaining the small surplus that emerged that year. In 1970, the spending constraint of the previous year ended, and government spending rose more than 6 percent, above the rate of inflation and above the rate of growth in nominal output. Yet that does not tell half the story. The Vietnam

⁷ For two articles utilizing this framework to analyze changing budget priorities over time, see Dwight Lee and Richard Vedder, "Friedman Tax Cuts vs. Buchanan Deficit Reduction as the Best Way of Constraining Government," *Economic Inquiry*, October 1992, or their "The Political Economy of the Peace Dividend," *Public Choice*, July 1996.

⁸ Richard Vedder, Lowell Gallaway and Christopher Frenze, *Taxes and Deficits: New Evidence*, Study prepared for Senator William Roth and Representative Richard Arney, Joint Economic Committee, United States Congress, October 30, 1991.

War was starting to wind down, and defense spending fell in nominal terms (and sharply in real terms). Non-defense spending rose an extraordinary 13.6 percent, compared with 5.1 percent the previous year (less than the rate of inflation). Real output rose very little in 1970, as the economy had what might be called a growth recession, with total employment and output rising slightly, but less than normal, leading to some increase in unemployment. Still the Nation did not go into a full blown recession that might have conceivably explained the rise in government spending. Spending for non-cyclically related categories like “health,” “Social Security” and “other” all rose by double-digit amounts. A robust budget picture in 1969 led to a spending boom in 1970.

While President Nixon talked a tough line on the need to curb spending, “discussions of ways to cut expenditures...came to no conclusion, partly because the options were all unpleasant...”⁹ The President blamed the move to deficit financing on the weakening economy. It also was in 1970, that he told reporter Howard K. Smith, “Now I am a Keynesian in economics.”¹⁰ It is sentiments like this that perhaps explain the emphasis on spending enhancement during the modern era.

The 1948-49 Vanishing of a Surplus

After the conclusion of World War II, defense spending fell dramatically. While taxes were lowered slightly, the huge fall in spending led to surpluses by 1947. By 1948, the defense demobilization was essentially complete, and the Nation ran a healthy surplus of nearly \$12 billion - well over 4 percent of GDP, the biggest surplus of modern times. Yet within a year, it was all but gone. Why?

The overwhelming reason for the vanishing surplus was an increase in federal outlays of over 30 percent in a single year. Over 60 percent of the increase in spending related to national security and foreign affairs. The heating up of the Cold War after the Berlin Crisis of 1948 no doubt contributed to this. Military budgets were increased considerably, and foreign aid spending soared with the beginning of the Marshall Plan. The \$9 billion spending increase dwarfed the \$2.2 billion in tax reductions arising from changes in individual income taxation (e.g., the introduction of the joint return). The high wartime marginal tax rates remained. President Truman, however, blamed the 1948 tax reduction for keeping debt reduction from being greater, but the data suggest this was a distinctly secondary factor.¹¹ Truman was pushing, often unsuccessfully, an expensive domestic spending agenda, including a national health insurance program. The near disappearance of the

⁹ Herbert Stein, “The Fiscal Revolution in America, Part II: 1964-1994,” in W. Elliot Brownlee, ed., *Funding the Modern American State, 1941-1995* (New York: Cambridge University Press, 1996), p. 219. Stein was a key economic adviser to the Nixon Administration.

¹⁰ *Ibid.*, p. 228.

¹¹ Harry S. Truman, *Memoirs*, Vol. 2, *Years of Trial and Hope* (Garden City, NY: Doubleday, 1956), p. 37.

budget surplus, very dear to Truman's heart, was also not primarily a consequence of the relatively mild 1949 recession, which was only a factor in the last half of that fiscal year.¹²

The Declining Surplus of 1957

Like President Truman, Dwight D. Eisenhower fancied himself as a fiscal conservative, concerned about balancing the budget. In fiscal year 1956, President Eisenhower achieved his first budget with a surplus. The following fiscal year continued the prosperity of 1955 and 1956, with unemployment well below 5 percent and real output rising. Moreover, the Nation was at peace. Yet the budget surplus fell, only to disappear completely in 1958. Why?

The answer, again, is entirely on the spending side. Tax revenues rose a sharp 7.2 percent, or well over twice the rate of inflation. Taxes increased as a percent of national output, in large part propelled by the impact of partly inflation-induced bracket creep on marginal tax rates. Yet the government could not keep spending under control. President Eisenhower pushed large increases in foreign aid, funds for public school buildings, the development of the interstate highway system, etc. Expenditures for "social security" and "income security" combined rose an extraordinary 18 percent - during a period of great prosperity. To cite another smaller but perhaps typical example, Ike requested a 27.4 percent budget hike for the U.S. Information Agency, an increase that Congress refused to grant.¹³

While the Presidents discussed above - Truman, Eisenhower, and Nixon - had different personalities and political philosophies, each one of them responded to budget surpluses with budgets that led to high rates of increase in spending. Tax reduction was either ignored or, in the case of Truman, unsuccessfully opposed. Each President, to be sure, faced a Congress run by the opposing party (although for only part of the fiscal year in the case of Truman). Yet the historical evidence is that both the executive and legislative branches participated in the fiscal policies that led to the demise of budget surpluses. The lessons of early postwar deficit experiences reinforces the empirical evidence above that there is a strong tendency in the modern era to increase expenditures in response to any surplus that arises.

CONCLUSIONS

The possibility, which based on historical experiences seems very likely, that the current \$70 billion surplus will largely be used to finance increased government spending should be viewed with concern. There is abundant evidence that increases in government spending as a percent of total output are

¹² For a discussion of Truman's economic philosophy, see Alonzo L. Hamby, *Man of the People* (New York: Oxford University Press, 1995), passim, for example, pp. 372-386

¹³ See Dwight D. Eisenhower, *Waging Peace, 1956-1961* (Garden City, NY: Doubleday, 1965), Chapter V, pp. 127-147, for his evaluation of the budget issues of this period.

accompanied by lower rates of economic growth in modern day America.¹⁴ The three periods in 20th century American history where there has been a sustained reduction in federal spending as a percent of total output, 1923-29, 1983-89, and 1992-98 have all been periods of prosperity and high economic growth. In each period the stock market reached historic highs, job growth was robust, and consumption levels rose sharply for the American people.

Accordingly, public policy that promotes moderation in expenditure growth will likely promote continued economic prosperity. The results above suggest that surpluses, such as achieved in fiscal year 1998, typically lead to higher government spending. Thus a strong case can be made that tax reduction, by reducing the magnitude of budget surpluses, will reduce the pressures on the federal government to increase spending faster than output. Such reduction might also deal with some of the inefficiencies in the existing tax code.¹⁵ The political dynamic of the budget process suggests that tax reduction may be doubly useful to the Nation: first, lower taxation can increase incentives to work, save, and invest; and second, such tax reduction might reduce the crowding out of productive private sector activity resulting from higher government spending.

The American Social Security system is in need of significant reform, and it well may be that the federal government will make this a key priority in the coming biennium. In a world without political pressures, a reasonable case could be made to try to maintain budget surpluses in order to give maximum flexibility to Congress and the Administration as they evaluate proposals to reform the Social Security system. The historical evidence suggests, however, that the prospects of maintaining budget surpluses are small, given the high propensity to spend out of surplus revenues.

¹⁴ See our *Government Size and Economic Growth*, Study, Joint Economic Committee, United States Congress, December 1998; Richard Vedder, "Economic Impact of Government Spending: A 50-State Analysis, Policy Report #178 (Dallas, TX: National Center for Policy Analysis, April 1993), and Gerald W. Scully, *Constitutional Environments and Economic Growth* (Princeton, N.J.: Princeton University Press, 1992).

¹⁵ On this point, see our *Some Underlying Principles of Tax Policy*, Study, Joint Economic Committee, United States Congress, October 1998.