

CRS Report for Congress

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Budget Surpluses: Economic Effects of Debt Repayment, Tax Cuts, or Spending — An Overview

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Summary

Updated projections released on July 15 by the Congressional Budget Office (CBO) indicate budget surpluses rising from \$63 billion (0.9% of GDP) in FY1998 to more than \$100 billion (1.3% to 1.5% of GDP) from FY2002 through FY2005 and over \$200 billion (1.8% to 1.9%) from FY2006 through FY2008.¹ Tax cuts or spending increases now being discussed would erode these estimates. Surpluses would increase national saving, reduce federal debt and release funds for use by private investors and other levels of government. Part would be transferred abroad, but domestic investment should rise by a sizeable fraction of the surpluses, and economic growth should quicken slightly. Transferring surpluses to Social Security or to related retirement accounts could have much the same effect. If projected surpluses occurred, the interest share of federal outlays and the federal-debt/GDP ratio would decline by 2006 to below the levels of the mid-1970s.

Eliminating surpluses through tax cuts would channel funds partly to increased consumption, but the interest share of federal outlays and the debt/GDP ratio would fall substantially with balanced budgets even without surpluses. Eliminating surpluses through increases (or smaller cuts) in federal entitlement spending would foster consumption, but using them to fund investment projects could boost economic growth somewhat, provided that the investments had social rates of return rivaling those of private investments. Surpluses are expected to vanish after 2010; tax cuts or spending boosts not then repealed or offset would increase future deficits.

After three decades of federal budget deficits, analysts now foresee a possibility of several years of black ink on the federal bottom line. Under current policy CBO projects surpluses just under 1% of GDP for this and the next 3 fiscal years, followed by larger

¹This report presents an overview of CRS Report 98-346, which spells out the analysis in greater detail.

surpluses that rise to 1.8% or 1.9% of GDP from FY2006 through FY2008 (CBO, *The Economic and Budget Outlook for Fiscal Years 1999-2008: A Preliminary Update*, July 15, 1998). Current policy includes future spending cuts agreed to in the Balanced Budget Act of 1997 but not yet specified. After FY2010 surpluses are likely to decline and vanish because of steep rises in outlays for Social Security and Medicare as the baby boomers begin to retire. Hence the prospective surpluses are of limited size and duration. This report examines economic and budget implications of alternative responses to them.

Repaying Federal Debt

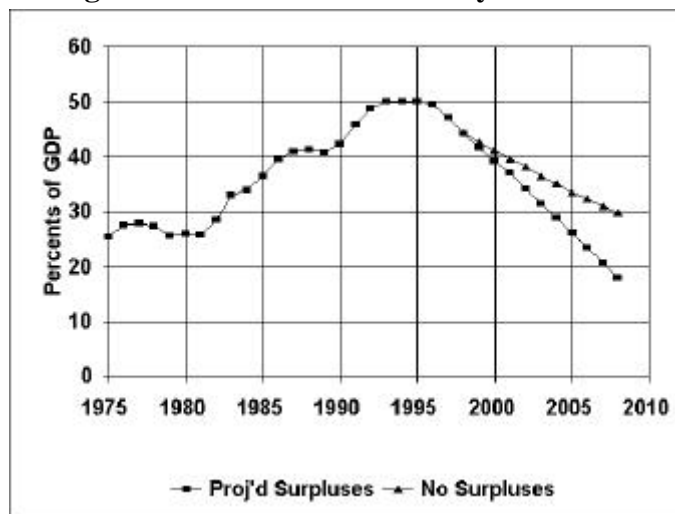
Federal debt peaked after World War II compared to the size of the economy that generates revenues to meet federal obligations. In FY1946 debt held by the public was 109% of GDP. During the early postwar years GDP grew faster than the debt until by FY1974 the debt stood at 24% of GDP. The percentage rose again, however, from 26% of GDP in FY1981 to 50% by FY1993, where it remained in FY1996.

Heavy federal borrowing since 1982 is thought to have resulted in higher real interest rates (nominal rates minus expected inflation), somewhat less investment than otherwise and slightly slower real economic growth. While the economy has generated many jobs and attained full employment in two long business expansions since 1982, average productivity and income per hour worked have grown slowly until the last year or so. Real interest rates remain high, as risk-free Treasury bills pay 5% while inflation is running at less than 2%. With the federal budget now in surplus, these high rates must be traced to low private saving together with heavy private credit demand at an advanced stage of a business expansion.

The Arithmetic of Reducing Federal Debt. So long as GDP is growing, the budget need not be in surplus for the ratio of federal debt to GDP to fall. The ratio declines whenever the outstanding debt rises by a smaller percentage than GDP, including inflation. The ratio of publically held debt to GDP fell from 50.1% in FY1995 to 47.3% in FY1997, even though the budget remained in deficit.

Figure 1 shows federal debt as percents of GDP from FY1975 through FY1998, plus two projections for FY1999-FY2008. A cash buildup in Treasury accounts would go to debt reduction in the normal course of Treasury cash and debt management. As the line labeled “proj’d surpluses” indicates, the debt-GDP ratio would fall under CBO’s baseline projection from 47.3% in FY1997 to 18% in FY2008. From FY1996 through FY2008 the ratio would more than reverse the upward course it had taken in the equal time period from FY1981 through FY1993, even though the surpluses would be much smaller than the earlier deficits. The downward course is

Figure 1. Federal Debt Held By the Public



quicker and easier because the denominator of the ratio — the GDP — grows steadily.

The debt-GDP ratio would fall substantially, however, even if the projected surpluses were eliminated through tax reduction or additional spending. With no surpluses, as seen in **Figure 1**, the debt at the end of FY2008 would be 29.9% of GDP. (The debt would remain roughly constant, but GDP would grow by 62% between FY1997 and FY2008.)

The Economic Effects of Reducing the Debt. The baby-boomers' retirement will impose heavy stress for many years on the federal budget and economy, and many economists believe that the nation should brace itself for the challenge. Debt reduction would simultaneously (1) add to private investment and expand national income from which to pay the heavy fiscal obligations ahead and (2) reduce the share of federal spending taken by interest payments.

Debt Reduction and Economic Growth. Maintaining budget surpluses and retiring federal debt would release funds for investment in other assets. Income would rise by the return to capital created by this investment. One should not, however, overstate the size of this increase in the context of the national economy.

CBO projected in 1995 that elimination over 7 years of a deficit equal to about 3.5% of GDP could reduce real interest rates by one to two percentage points but might boost the growth of real GDP by only 0.1% annually. While this acceleration of growth would accumulate over time, it would raise GDP by little more than 1% in 10 years.²

In contrast to that earlier scenario, surpluses in CBO's latest baseline projection would rise to less than 2% of GDP over 11 years (FY1998-FY2008 inclusive) and soon thereafter are likely to decline. Compared to balanced budgets with no surpluses, the surpluses now projected are likely to have only slight effects on economic growth. When added to those of deficit elimination since 1992, however, the effects could be discernible.

Reducing the Outlay Share of Interest Payments. Net interest payments have risen since FY1980 from 9% to 15% of the federal spending pie. This placed steady upward pressure on deficits and on tax rates and downward pressure on program expenditures. Surpluses projected in CBO's baseline through FY2008 would reduce the interest share of outlays back to 6.1%. A balanced budget with no surpluses would scale them back to about 9.4% or less.

By reducing the budget pressure posed by interest payments, a period of balanced or surplus budgets would permit the federal government to shoulder the initial burden of entitlements for retiring baby boomers with somewhat lower spending levels and lower taxes. Less debt also would position it better to finance future entitlements in part by borrowing and to rely less heavily on tax increases and cuts in other spending programs.

²Congressional Budget Office, *The Economic and Budget Outlook: An Update*, September 1995, p. 42 f.

Channeling Surpluses into Social Security

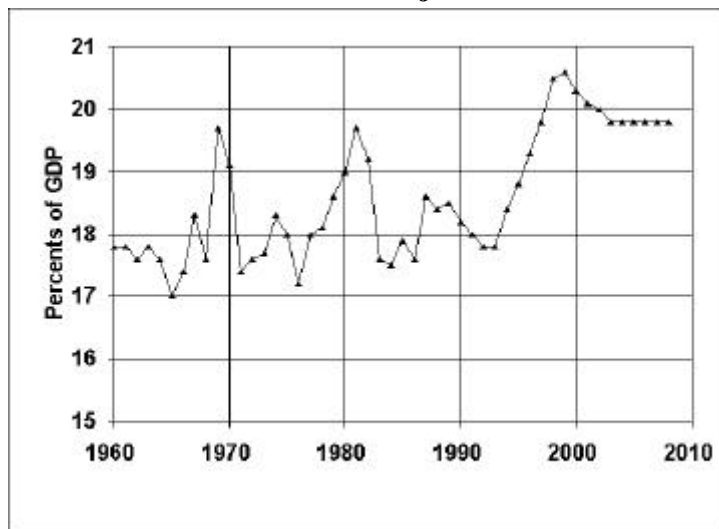
Several proposals have been made to channel budget surpluses at least in part into Social Security's trust fund or into government-mandated retirement accounts. Either option would direct surplus revenues into saving and investment with equal benefits for economic growth, provided it does not become a substitute for other measures raising revenues or trimming benefits that otherwise would be taken. Either option could defray future government liability to pay retirement benefits, although they would not reduce outstanding federal debt or interest payments in the short run.

Cutting Taxes

As shown in **Figure 2**, Federal revenues as a share of GDP have fluctuated since 1960 between 17.0% and 19.8%. These amounts include not only personal income taxes but also social-security taxes, corporate taxes, excises, estate taxes, and other receipts. The upper end of the range was reached, at 19.7%, in FY1969 and again in FY1981. Since FY1993 the tax burden has climbed steadily from 17.8% of GDP to a post-World-War-II high of 19.8% in FY1997. This rise occurred because of increased

top-bracket tax rates and rising incomes, including capital gains, among high-bracket taxpayers. CBO projects that the ratio will reach 20.5% this year and 20.6% next year before subsiding to 19.8% by FY2003 if no further tax changes are made. It would remain above the high end of the historical range.

Figure 2. Federal Revenues as Percents of GDP: FY1960 to FY1997 with Projections to FY2008



Tax Rates in Historical Perspective. In 1981 the personal tax code had 15 rate brackets with marginal rates rising from 16% to 70%. The Economic Recovery Tax Act of 1981 reduced marginal rates by nearly one-fourth across the spectrum. The top rate dropped by slightly more to 50%. The Tax Reform Act of 1986 reduced the number of statutory marginal tax rates to only two and cut the top marginal rate on personal income sharply from 50% to 28%.³ Despite the dramatic reduction in the top marginal tax rate, however, some 40% of taxpayers are estimated to have faced higher marginal rates after the 1986 Act than before.⁴ The top rate on corporate income was scaled back from 46%

³Because of the phaseout of the personal exemption over a certain high income span, the effective marginal tax rate rose to 33% on income within that span but then reverted to 28%.

⁴Jerry A. Hausman and James M. Poterba, Household Behavior and the Tax Reform Act of (continued...)

to 34%. Losses of revenue due to lower tax rates enacted in 1986 were made up by limiting or eliminating various tax preferences, thereby increasing the amount of income that was taxed.

Since 1990, in the quest to curtail budget deficits, top marginal tax rates on personal income were raised in two steps from 28% to 39.6%, although the higher rates apply only to taxpayers in roughly the top 5% of the personal income distribution. The rate on most corporate income was boosted slightly from 34% to 35%. The Taxpayer Relief Act of 1997 affected marginal tax rates only by lowering those on capital gains from assets held more than 18 months. It created new tax preferences — a child tax credit, a tuition tax deduction and credit, and new variants of individual retirement accounts — reversing some of the tax-base-broadening effect of the Tax Reform Act of 1986.

Economic Effects of Cutting Taxes. Unlike budget surpluses, which go into saving, tax reductions are likely to go in substantial part into consumption. Cuts in middle-class income taxes, payroll taxes or excise taxes, for instance, go primarily into consumption with little effect on the growth of production capacity. Cuts in corporate income taxes and those on other income from saving and investment may go to a larger extent into saving, although evidence of this is inconclusive.

Beyond redirecting surplus revenues from the Treasury into private hands for consumption or saving/investment, tax reductions can affect future productive behavior. By permitting workers, savers, and investors to keep larger shares of the income from additional productive activity, lower marginal tax rates raise the monetary reward of extra work compared to the pleasure of leisure — an incentive to substitute work for leisure. Likewise, they boost the future reward for more saving and investing compared to utility of present consumption. This argument is the basis of the “supply-side theory” relating levels of taxation to economic growth. Aside from questions about the strength of these incentives, basic economics indicates that this is only half of the story.

Lower taxes also mean that workers and/or savers would have more after-tax income *without* more work or more saving. They could even have more income *and* more leisure, or more consumption today *and* in the future. Under economists’ standard assumptions the desire to work or to save would be weaker because of the increase in after-tax income. This so-called “income effect” of a tax cut offsets the “substitution effect” emphasized by the supply-side theory. Workers or savers with fixed income targets could actually reach their targets with less work or less saving and might even be motivated to cut back their effort. Hence, the net effect of lower taxes on work, saving and investment is not clear in theory. Efforts to measure an effect statistically also have reached inconclusive results.⁵

In conclusion, maintenance of surpluses and reduction of debt (or diversion of surpluses into retirement accounts) are likely to contribute more than tax reduction to capital formation as well as to the government’s fiscal position. Debt reduction,

⁴(...continued)

1986, *Journal of Economic Perspectives*, v. 1, n. 1 (summer 1987).

⁵Alan J. Auerbach and Joel Slemrod, The Economic Effects of the Tax Reform Act of 1986, *Journal of Economic Literature*, v. 35, n. 2 (June 1997), p. 626.

moreover, would begin when surpluses occur and would end when they end. Taxes could be cut in expectation of budget surpluses and, unless raised again when deficits return or offset then by spending cuts, would *reduce* private investment from what it would be with balanced budgets.

Tax cuts envisioned by the concurrent resolutions on the FY1998 budget passed by the House and Senate (**H.Con.Res. 284** and **S.Con.Res. 86**) are to be offset by spending cuts and should not affect potential surpluses. In light of new projections showing larger budget surpluses, however, some Republican leaders, especially in the House, favor substantially larger tax cuts financed by dipping into expected surpluses.

Boosting Spending

Increases in government transfer payments can add directly to private consumption. Increases in other government spending can boost communal consumption and investment through provision of “public goods” like national defense, basic research and the administration of justice.

Federal Programs Fostering Consumption. Federal programs fostering consumption are mainly transfer programs to the elderly, the unemployed, the disabled and the poor. Since 1981 most changes in law and policy have curtailed spending on these transfers from what it otherwise would have been. While legislation increasing entitlements seems unlikely, budget surpluses could be devoted to moderating future cutbacks. They could provide relief only for a few years, however, because of the likelihood that surpluses will not persist beyond 2010. Longer-term increases in entitlements, unless offset by additional revenues or by spending cuts elsewhere, would mean larger deficits in future years.

Some social programs enhance productivity and thus have the nature of investment. Among these may be health-care, nutrition and education programs for poor children, which foster healthier, better educated future workers, and child care for children of low-paid workers, which may be critical to allowing such workers to join the labor force.

Federal Investment Spending. Many programs in the federal government’s discretionary budget contribute to national investment and to economic and social progress. Examples are those adding to research, technology development, education, training, and physical infrastructure. To the extent that these investments yield social returns equal to or greater than those of marginal private investments, spending on them should be regarded as high-return investments and as additions to national saving.

The Transportation Equity Act (**P.L. 105-178**), signed into law on June 9, will increase spending for transportation capital for 6 years by an average of about \$3 billion per year above amounts envisioned by the Balanced Budget Act of 1997. This added spending for roads and mass transit is to be offset, in part by reversing a ruling of the Veterans Administration allowing disability benefits for veterans with smoking-related illnesses who began smoking in the military. The Emergency Supplemental Appropriation Act of 1998 (**P.L. 105-174**) allotted \$5.6 billion in this fiscal year for disaster relief and for military operations in Bosnia and the Persian Gulf. About \$3 billion for military operations will not be offset and will reduce the FY1998 surplus.