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Jan Walliser\*

# Budget Surpluses and Social Security Reform: U.S. Fiscal Policy Issues in 1998

*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.<sup>1</sup> 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.<sup>2</sup>

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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<sup>1</sup> See Congressional Budget Office: The Economic and Budget Outlook: Update, Washington, D.C., August 1998.

<sup>2</sup> The sustainability of fiscal policy can alternatively be measured with generational accounts. For recent results see Jagadeesh Gokhale, Benjamin Page, John Sturrock: Generational Accounting for the United States: An Update, in: Economic Review of the Federal Reserve Bank of Cleveland, Fourth Quarter 1997.

### 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.<sup>3</sup> 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

<sup>3</sup> The tax code gives preferential treatment to capital gains. Also, assets that become part of an estate are usually not subject to capital gains taxes.

GDP is assumed to grow smoothly by averaging over possible cyclical ups and downs of the economy.

### Budget Surpluses and Social Security's Finances

In the United States, policymakers generally take a long-run view of Social Security's finances. In contrast to many other countries with pay-as-you-go financed public pension systems, the Congress does not adjust the Social Security payroll tax annually according to expected Social Security outlays. Instead, policymakers refer to the long-run projections of the Social Security Board of Trustees. Those projections show the financial position of the Social Security system over a 75 year horizon. According to the most recent projections, the current payroll tax of 12.4 percent would have to be raised today by 2.2 percentage points to balance the system over the

next 75 years.<sup>4</sup> If one takes a look into the future that goes beyond the next 75 years, the payroll tax would have to rise by about 4.6 percentage points.<sup>5</sup> Alternatively, if the current payroll tax rate were maintained, benefits would have to be cut by 25 percent after 2032.

Nonetheless, currently the payroll tax revenues exceed annual Social Security outlays. It was the long-run perspective that led policymakers to increase the payroll tax to its current level in 1983. Ever since, the Social Security Trust Funds have been in surplus, accumulating assets in the form of government bonds

<sup>4</sup> 1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., 1998.

<sup>5</sup> Calculation by Steve Goss, Deputy Chief Actuary, Social Security Administration.

Yves Hervé/Robert Holzmann

## Fiscal Transfers and Economic Convergence in the EU: An Analysis of Absorption Problems and an Evaluation of the Literature

This book is the presentation of a study that the authors, director and research assistant at the European Institute of the University of Saarland, did on behalf of the European Commission. In view of the actual debate on the future of EU expenditures for regional and structural policy programmes, they were charged with summarising the state of knowledge of the academic world on economic problems linked to large scale fiscal transfers to economically backward countries.

Firstly, the authors define a dynamic efficiency criterion with which to assess the extent of transfer-related economic problems. Based on that, they explain in detail a multitude of potential problems and why the extent of these problems is likely to be positively correlated with the scale of transfers. Since most the problems have been neglected in existing studies assessing the growth effects of EU fiscal transfers, the estimates of these studies are probably too optimistic.

The book is of interest to all readers who are professionally concerned with the analysis of inter-governmental fiscal transfers, both within and between countries.

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of \$656 billion by the end of 1997. Current projections by the Board of Trustees show that the Social Security system is expected to run surpluses until 2012.

Social Security's surpluses contribute to the 1998 budget surplus of \$70 billion. The commonly reported surplus is based on the unified budget concept that encompasses all federal government activity including Social Security. The 1998 unified budget surplus is composed of a Social Security surplus of over \$100 billion in 1998, whereas the rest of the budget was in deficit by some \$40 billion.

Looking at Social Security's finances in isolation can therefore be quite misleading. The Trust Fund balances constitute assets for Social Security, but they are only an internal accounting device for the overall federal government. Until 1998, the government excluding Social Security ran a deficit that exceeded Social Security's surplus. Social Security's surplus financed the deficit in other parts of the government but it did not lead to any accumulation of assets by the government as a whole. Therefore, the Trust Fund simply signifies that other parts of the government owe money to Social Security. Once Social Security's Trust Fund takes in less than it pays out some time after 2012, the federal budget will come under increasing pressures when the rest of the federal government must pay back the money it borrowed from the Trust Fund.<sup>6</sup>

Another danger of looking at Social Security in isolation is that it may cause confusion about the meaning of a unified budget. It may appear as if the unified surplus and Social Security's surplus exist in parallel, and that the unified surplus signifies additional resources. However, as discussed above, the unified surplus reflects Social Security surpluses, and thus Social Security's finances and the unified surplus cannot be evaluated in isolation.

Studying overall government expenditures and revenues is also important to understand the long-run impact of fiscal policy. As CBO's long-term budget model shows, paying down the federal debt with the projected surpluses would ease future budgetary pressures but could not put fiscal policy on a

sustainable path. The implication of that finding is quite simple: today's surpluses, even if they arise as projected, are not sufficient to pay all future entitlements under current law when baby boomers retire. The corollary of that finding is that achieving a sustainable fiscal policy requires some changes to expenditures and revenues as set by current law.

### Proposals for Change

Could the projected surpluses be used to save Social Security? Let's first take a look at what would happen under current law, that is without making any policy changes. Under current law, the unified surplus – synonymous with positive government saving – would reduce the debt held by the public. Reducing the government's indebtedness reduces future government interest payments and thus future budgetary pressures. In that respect, the surpluses help Social Security indirectly by making it easier for the rest of the government to meet its obligations to the Social Security Trust Fund in the next century. However, under current law the projected surpluses do not directly help Social Security because they change neither the projected outlays nor the projected revenues of the program.

Some have therefore suggested transferring additional resources of approximately the size of the surplus to the Social Security program. Such a policy could be accomplished in different ways. One way would be to increase the resources of the Social Security Trust Fund by transferring money from the rest of the budget to Social Security. Some analysts additionally call for allowing the Trust Fund to invest in the stock market. A second way would be to transfer the money to workers but to use the money to reduce future Social Security outlays.

The two views were recently represented by Henry Aaron and Martin Feldstein in a Hearing of the Senate Budget Committee.<sup>7</sup> Aaron argued that the surplus should be transferred to a fund separate from the budget that could be invested in a variety of assets including stocks. The returns of the fund should then be used to finance Social Security benefits as determined under current law. Feldstein, by contrast, would like to set up personal retirement accounts with an income tax credit of 2 percent of payroll. Workers could invest their account balances in the financial markets. After they reach retirement age, they would have to withdraw their account balances and Social Security benefits would fall by 75 cents for each dollar withdrawn from the accounts.<sup>8</sup>

<sup>6</sup> It is still possible that because of the increase in payroll taxes in 1983 the government deficit is lower than it otherwise would have been. In other words, the 1983 payroll tax increase may have reduced government dissaving and thus increased national saving. See also Kent Smetters: *Thinking About Social Security's Trust Fund*, in: Olivia Mitchell, Robert Myers, Howard Young (eds.): *Prospects for Social Security Reform*, Philadelphia, University of Pennsylvania Press, forthcoming.

<sup>7</sup> Hearing of the Senate Budget Committee on July 23, 1998.

Neither of the plans could put fiscal policy on a sustainable path. Under both plans general revenues would be shifted to the Social Security program, improving Social Security's finances at the expense of the rest of the federal budget. Neither of the two plans would improve the overall budgetary outlook compared with paying down the debt under current law because under both plans the overall government resources would be limited by the funds collected under current law, and under both plans existing resources would have to pay for at least as much as the current Social Security benefit. However, Aaron's plan would send the money directly to Social Security, whereas Feldstein's plan would rebate taxes to workers today but would then reduce Social Security benefits later when workers withdraw their retirement savings. In fact, because Feldstein's plan would not reduce Social Security benefits dollar for dollar when workers access their retirement accounts, it would likely increase budgetary pressures compared with current law.

The plans differ, however, in two important details:

First, Aaron's plan would leave investments under government control. Proponents of that approach argue that it is important to provide predictable benefits based on previous earnings rather than the performance of financial markets. Opponents of such a policy argue that the government may intervene in possible investment policies, reducing the return of the pension fund. Interestingly, in a recent debate even the President seemed to indicate that Americans would not trust a government-run pension fund.<sup>9</sup>

Second, depending on the specifics, setting up a government-run pension fund may leave the unified budget surplus unchanged. Thus far none of the budgetary authorities has addressed the question of the budgetary treatment of such a fund, and their views would largely depend on specific characteristics of the legislative framework. If budgetary authorities perceived all the assets of Aaron's government-run pension fund as part of government wealth, transferring money between the fund and the rest of the budget would be a pure asset swap, leaving the unified surplus unchanged. The tax credit under Feldstein's proposal, by contrast, would reduce tax revenues, reducing the unified budget surplus

dollar for dollar. As Feldstein argues, a unified surplus could encourage policymakers to increase spending or cut taxes. Feldstein therefore perceives his proposal as a way to remove resources from the budgetary process and reserve them for Social Security.

Aaron's and Feldstein's proposals are a reflection of the recent policy debate on Social Security reform. In 1997, the Advisory Council on Social Security released a report that presented three proposals on how to restore the program to actuarial balance. One of the proposals also suggested keeping the existing system largely unchanged and under government control, whereas the two other proposals favored personal retirement accounts. Unlike the proposal by Feldstein, however, the two Advisory Council plans with personal retirement accounts scale back government benefit guarantees. Therefore, they could improve long-run government finances rather than simply preserving the current fiscal stance.

### Conclusion

The 1998 fiscal year resulted in a US budget surplus for the first time since 1969. Fueled by thus far unexplained increases in government revenues, the surplus reached \$70 billion or 0.9 percent of GDP. Surpluses of 1 to 2 percent of GDP are also expected for the next 10 fiscal years. Those surpluses have contributed to a debate about the long-term finances of the Social Security system. Some proposals have emerged that would set aside the surplus for future Social Security spending. The approaches differ in whether the government or workers would make investment choices. The proposals that focus only on preserving the budget surplus have in common that they cannot tackle the long-run sustainability of fiscal spending, because they do not change the overall resources that are available to the government. Thus, despite the projected surpluses further policy changes will be necessary to return US policy to a sustainable path. It is possible that such larger structural changes to the Social Security program might emerge from the debate between the President and the next Congress. Nonetheless, the current stance of fiscal policy constitutes a vast improvement over the situation just a few years ago, and policymakers in many countries would probably prefer to swap the US fiscal problems for their own.

<sup>8</sup> For a detailed description and analysis of Feldstein's proposal see "Letter to the Honorable Bill Archer regarding Professor Martin Feldstein's proposal to create personal retirement accounts financed with tax credits," Congressional Budget Office, August 4. The letter is also available at <http://www.cbo.gov>.

<sup>9</sup> "Americans believe that the government can mess up a two-car parade." President Bill Clinton in Albuquerque, New Mexico on July 27, 1998.