STRATEGIES FOR PUBLIC BUDGETING IN HISTORICAL PERSPECTIVE: AN ANALYSIS OF U.S BUDGET SURPLUS OF 1999

S. M. Taha*

Abstract

Budget surplus is a rare phenomenon in countries' life. Countries, in general, deal with a common problem, that is, 'deficit'. United States had experienced the problem of budget deficit that persisted for decades. After a long struggle, the federal budget scenario gradually changed during the last half of 1990s. This change started with gradual decline in the deficit from 1993 to 1996, than it became close to balance in 1997 and finally moved into surplus in 1998 for the first time in the history of United States. Social scientists and historians put forward number of reasons for the budget surplus, such as, individual income tax receipts, slower growth of medical costs, lower interest rates, economic growth, and the 1990 and 1993 deficit-reduction laws.

Budget surplus was an unprecedented phenomenon for policy makers and practitioners. They interpreted it from different angles. Both political parties, Republican and Democrat had different views on the budget proposals. Number of proposals had been put forward from both parties. President Clinton proposed reducing the projected surpluses by 32 percent through spending increases for defense, education, and other programs, and tax cuts to fund individual saving accounts. Congress (dominated by Republican), on the other hand, adopted a budget resolution that proposed tax-cut strategies to reduce the projected surpluses.

This paper examines factors responsible for that surplus and evaluates the presidential and congressional proposals for the utilization of surplus.

* S. M. Taha, Assistant Prof, Department of History (Gen.), University of Karachi, Karachi, Pakistan

Retrospective Look on the Budget

To understand the budget surplus of 1999 in United States, retrospective look of budget policy will present the phenomenon clearly and will highlight some of the important trends to the surplus issue. The period of 1962 to 1974 showed steady decline in the ratio of publicly held federal debt to gross domestic product (GDP). Outlays went up sharply as a share of GDP in 1966-68, but receipts also increased because of income tax generation. This trend of decline in the debt-to-GDP ratio was stopped in 1974, and the ratio remained relatively constant until 1981. Outlays increased during this period, but receipts also increased as high inflation pushed taxpayers into higher individual income tax brackets. In the decade of eighties, the stability in debt-GDP ratio got disturbed and reached to nearly double. This trends remained intact in the first three years of 1990s, pushed the debt equaled 50 percent of annual GDP, the highest level since 1956. Receipts declined as a share of GDP as a result of the 1981 across-the-board income-tax rate reduction, while outlays grew[1].

The debt-to-GDP ratio declined after 1993, falling to 44 percent in 1998. Both, increasing receipts and reducing outlays, as share of GDP, achieved this decline. In 1998, the ratio of receipts to GDP was at its highest level since 1994, and the ratio of outlays to GDP was its lowest level since 1974.

Budget laws introduced fundamental change in the structure of outlays. These laws divided non-interest spending into two categories: entitlement and discretionary programs. The 1995 version of reconciliation had the potential to be the "mother of all reconciliation bills. Relying heavily on major cuts in Medicare, one of the most popular entitlements programs in the budget, the 1995 reconciliation bill also included, for the first time in the history of reconciliation, a major tax cut as one of its provisions[2].

Annual appropriation bills approved by the Congress and the President allowed discretionary spending. In 1999, half of all discretionary spending went to national defense, while the rest allocated to a wide range of programs such as highways, law enforcement, and national parks. Entitlement programs did not require annual appropriations because Congress and the President had permanently authorized them to pay benefits to eligible individuals based on formulas set by law. Only Congress and the President could cap these programs through changes in the law. In 1999, Social Security, Medicare, and the federal share of Medicaid received three-quarters of entitlement spending. The other quarter covered a range of smaller programs, including veterans' benefits, unemployment compensation, farm subsidies, and welfare.

Gradual reduction in the deficit took place during 1992 to 1996 ($290 billion in 1992 to $107 billion in 1996). The course of economic events and policies together resulted to this decline in deficit. The continued economic growth increased receipts, and lower

[1] Office of Management and Budget (1999), Historical Tables, Budget of the United States Government, Fiscal Year 2000 (Washington D.C) pp. 110-111.

[2] Richard Doyle, "Congress, the Deficit, and the Budget Reconciliation, in Public Budgeting & Finance, Winter 1996, vol. 16, number 4.p.59-60

nominal interest rates reduced the expense of government's interest. Deficit reduction laws of 1993 played an important role in decline of deficit. These laws tightened Medicare reimbursements to health care providers, increased income and excise taxes, and locked in fiscal discipline through the Budget Enforcement Act (BEA).[3]

The Budget Enforcement Act adopted for fiscal year 1991-95 by the 1990 law and extended to 1998 by the 1993 law, imposed two important restrictions on budget policy. First, it capped nominal discretionary spending at approximately $550 billion throughout this period, reducing defense and non-defense discretionary spending as shares of GDP. Second, the BEA imposed a pay-as-you-go rule that prohibited any change in the laws to reduce taxes without reducing entitlement spending or to increase entitlement spending without increasing taxes, although it did not require any action to offset the entitlement growth built into current law. The discretionary cap and the pay-as-you-go rule could be waived if congress and the president designated a measure as an emergency.[4]

The steady deficit decline from 1993 to 1996 pushed the budget close to balance in 1998. The new budget laws introduced in August1997 profoundly altered the budget. In 1996, CBO's ten-year forecast predicted large and growing surpluses, if budget laws were enacted.

The predicted surplus showed increase to $381 billion in 2009, with the publicly held federal debt (which is reduced by each year surplus) declining from $3.77 trillion on September 30, 2009.[5]

However there were some qualms looming over the budget projection. The report of the National Performance Review (the Gore Report) in 1993 pointed out that agencies must estimate what they will need to run programs in the fiscal year that had to begin almost two years later of this report[6].

The Gore Report also pointed out that the agency officials inflate their estimates that pushed the national budget on higher side. Report claimed that agencies asked regularly for 90 percent more than they eventually receive. It was suggested in the report to curb this practice of mentioning higher figures than what actually required[7].

As with ten-year forecast, the projection of a $381 billion surplus in 2009 was subjected to considerable doubt. CBO predicted that the gradual decline in GDP growth, permanent increase in nominal interest rate, growth of medical cost and individual

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3 Op. Cit., pp. 169-170

4 Samuelson, Robert J. "The 'surplus' Surplus", Washington Post, May 20, 1998, p. A25.

5 Congressional Budget Office (1996), The Economic and Budget Outlook: Fiscal Year 1997-2006 (Washington D.C), pp. 66.

6 From Red Tape to Results: Creating a Government that Works Better & Costs less, Report of the National Performance Review, Vice President Al Gore, September 7, 1993 (Washington, D.C, Government Printing Office, P. 14

7 Ibid p. 15-16

income tax receipts would reduce the surplus by $60 billion. It was also predicted that the expected increase in the entitlement spending will first reduce the surpluses and then will put the budget back into deficit after 2020. The anticipated increase in spending results from two long-term trends. First, the dependency ratio (the ratio of the population aged 65 and over to those aged 20 to 64) would extend with the expansion of life spans. Second, despite slow growth in 1990s, medical costs were expected to resume their rapid increase. Federal Medicaid spending was also expected to rise sharply.
CBO also predicted that a permanent tax increase or spending cut of 0.6 percent of GDP would put back long-term balance, if it were implemented straight away. The essential tax increase or spending cut would be larger if it is delayed.

Most of the long-term projections were subjected to even greater ambiguity than the ten-year forecasts because economic growth, the relative price of medical care, fertility, and life expectancy were difficult to predict over an extended horizon. However the statistical estimate of the mortality rate suggested that the increase could be twice as great, which would further increase social security and Medicare costs and the size of the long-term fiscal imbalances.[8]

The projections of surpluses assumed that Congress and the President had to adhere to the balanced budget act's limits on discretionary spending.

Proposal to Reduce the Projected Surplus

Budget surplus was surprise for policy makers. For the last two decades, there was widespread agreement in principle that the appropriate goal was to balance the budget. After 1981, proposals for large tax cuts or spending increase were consistently rejected. Some economists and policymakers continued to oppose tax cuts and spending increases, argued that the projected surpluses should be preserved. But others supported tax cuts or spending increases, which remained consistent with budget balance, although these measures reduced the projected surpluses.[9]

The August 1997 legislation offered tax credits for children and higher education costs, stretched the capital gains preference and tax-deferred savings opportunities, and created a new children's Health Insurance Program. June 1998 legislation modified the BEA to permit $20 billion to $30 billion of annual transportation spending outside the discretionary cap, and October 1998 legislation invoked the BEA's emergency exception to increase defense and non-defense discretionary spending by $17 billion in fiscal 1999 and $5billion in fiscal 2000.[10]

President Clinton, in his fiscal 2000 budget proposal, President Clinton proposed spending increases and tax cuts that was estimated to reduce by about 32 percent the

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8 Lee & Skinner (1999), "Will Aging Baby Boomers Bust the Federal Budget?" Journal of Economic perspective 13 (winter): 117-40.
9 Allan Sloan, "Reading between the Budget Lines", Washington Post, Feb. 10, 1998, p. C03.
10 Hollings Earnest F., "What Surplus"? , Washington Post. Feb. 5, 1998, p. A17.

cumulative surpluses projected during the next ten years. His proposals aimed at reducing the surpluses by 24 percent through spending increases for education, national defense, and other programs and by another 13 percent through tax cuts to fund individual savings accounts. However, it would increase the surpluses by 5 percent by raising tobacco and other taxes. Clinton's proposals mainly focused on spending increases and tax cuts adopted only after a Social Security reform was enacted.

On April 15, Congress adopted a fiscal 2000 budget resolution that reduced the projected surpluses by 27 percent, with a 35 percent reduction from unspecified tax cuts offset by 8 percent increase from spending cuts. Some congressmen suggested reducing individual income tax rates, while others called for tax cuts for two-income married couples, reform or elimination of the alternative minimum individual income tax, and further expansion of the capital gains preference.

It was hard to measure the consequences of these proposals. These proposals were evaluated by important criteria. First transfer of payments or tax cuts without touching the individual's saving, and second tax cuts that increased in the government's purchases of goods or services.

Could that policies affect national saving was the fundamental question. Few economic principles geared up the policy decisions. First was the national saving, which measures the portion of national income withheld from current consumption and invested to increase future consumption, equals the private saving by individuals and businesses plus government saving. Second was the surpluses that make up government saving, and deficits constitute negative government saving. Policy makers were fully aware that reducing the surpluses would reduce government saving, national saving would decline if private saving did not change. However, if private saving rose by an offsetting amount, national saving would be unchanged.[11]

Ricardian equivalence theory is one of the leading views that shows relationship between private and government saving. According to this theory, taxpayers realize the transfer payments or tax cuts they receive today will require tax increases or spending cuts in the future. To prepare for this burden, taxpayers increase their private saving by the full amount of the tax cut or transfer payment, leaving national saving unchanged. The key assumption is that individuals rationally plan their consumption based on their expected lifetime income.[12]

Proponents and opponents of Ricardian theory for the handling of surplus issue, debated over possible outcome of the tax cut in relation to consumption and national savings.

The reduction in national saving could result in increase of consumption and would reduce future national income and consumption. National saving could be invested in

[11] Burch, Hobart A. , Social Welfare Policy Analysis And Choice, New York: The Haworth Press, 1999, pp 258-260.

[12] Elmendorf & Mnkiw (1998), "Government Debt", Working Paper in National Bureau of Economic and Research, cited here form Burch, Op. Cit. pp. 218-235.

various forms of capital in the United States, including corporate and non-corporate business investment, owner-occupied housing, consumer durable, and human capital such as education or training, and could also use to purchase foreign assets. A reduced supply of saving would ultimately increase interest rates and reduce these investments. Limited supply of capital would lower the future income and consumption. Labor and workers would suffer part of the loss, because the reduction in the capital stock would lower labor productivity and real wages.

The consumption was depended on pre-tax rate of return to investment which was uncertain because of variety of shocks to the economy. Its expected value was estimated from the historical average of the ratio of pre-tax real net-of-depreciation capital income to the value of the capital stock.[13] The expected real return was calculated 6 percent to 7 percent per year, according to estimates.[14] The relatively high return implied that a reduction in national saving significantly decreased future consumption.

The reduction in national saving could be desirable no matter consumption would lost in the future was greater than the amount gained in the present. The important issue was that how the changes in consumption at each date affected human well-being. Decline in the national saving explained the relationship between consumption and human well-being. First, members of each generation might consume more when they are young and less when they are elderly. Second, current generations might consume more throughout their lifetimes, and future generations might consume less. Under certain circumstances, tax cuts or transfer payments could reduce national saving in either manner.[15]

Tax cuts and transfer payments could cause people to consume earlier in their lifetimes if they are subject to incomplete information. Individuals might not know whether their tax cut or transfer payment was financed by a reduction in the surplus that will trigger future tax increases or spending cuts or by an increase in someone else's taxes. In United States there was widespread unawareness and misinformation about the level of and changes in government debt.[16]

The assumption that individuals do not allocate consumption over their lifetimes in a perfectly rational, far-sighted manner is supported by empirical evidence. Campbell and Mankiw (1991) find that consumption rises when income rises, even when the income increase was predictable in advance, which contradicts the assumption that individuals prepare for predictable income changes by adjusting their consumption when they learn about the increases. Some studies indicate that approximately half of aggregate consumption being done by individuals who consume a constant fraction of their current disposable income, without regard to their future income. If these individuals receive tax

[13] Summer, Lawrence H. , What is Social Return to Capital Investment?, cited here from Epstein William M. "Welfare in America". Madison: The University of Wisconsin Press. 1997, p.133.

[14] Feldstein, Martin (1998), "Introduction" in Privatizing Social Security, ed. Martin Feldstein, Chicago: University of Chicago Press, pp. 1-29.

[15] Epstein William, Op. Cit., pp. 142-145.

[16] Allers, Maarten, Jakob de Haan, and Kam (1998), Using Survey Data to Test for Ricardian Equivalence", Public Finance Review, 26 (November): pp. 565-582.

cuts and transfer payments in the present, financed by tax increases and spending cuts in the future, they will increase their current consumption and reduce their future consumption.[17]

Saving and consuming behavior is likely to be fluid in its nature. Many individuals do experience important tax increases or benefit reductions when the federal government face the post-2020 budget challenge. Individuals who are unaware of this prospect or have not incorporated it into their prospect or have not incorporated it into their saving behavior may be consuming too much, but may consume less in future because of their insufficient saving. Tax cuts and transfer payments could further affect their well-being. On the contrary, individuals who overrate the severity of future tax increases or spending cuts may be saving too much, unnecessarily sacrificing current consumption to acquire excessive future consumption. Tax cuts and transfer payments could increase their well-being.[18]

Another problem lies in the tax penalty on saving. This penalty forced people to consume earlier in their lives than they would under a neutral tax system. If the taxation of saving cannot be waived, then persuade people into saving more would compensate the distortion caused by the tax system. This option seems flawed; however it could be preferable to directly eradicate the distortion by reforming the tax system.

Economists suggested that the effects of tax cuts and transfer payments remained static in terms of consumptions; however changes may occur in how much consumption is experienced by each generation. They believe that tax cuts and transfer payments would increase the consumption of earlier generations at the expense of later generations because later generations would bear part of the necessary future tax increases and spending cuts. Some historians argue largely the result of fiscal policies that transferred resources from later generations to earlier generations.[19]

The above proposition favors the argument that, the desirability of tax cuts and transfer payments are based on value judgments about the needs, rights, and obligations of different generations. Eisner argues that there is trivial reason to increase national saving because future generations will be wealthier than current generations.[20] However, some economists present mathematical calculations suggesting the utility gained by future generations would be greater than the utility sacrificed by current generations, because of the high rate of return from saving[21]. However, these analyses are questionable because they depend on the weights given to utility at different levels of wealth. These

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[17] Burch, Op. Cit., pp. 262-270

[18] Reischauer, Robert D., Those Surpluses: Proceed with Caution, Washington Post. September 21, 1997, p.C09

[19] Gokhale, Jagadeesh, Laurence J. Kotikoff, and Sabelhaus (1996), "Understanding the Postwar Decline in U.S Saving", cited in Op. Cit., Epstein, p.133.

[20] Eisner, Robert , "Must We Save for Our Grandchildren?" Wall Street Journal, June 3, 1998, p. A18.

[21] Romer, David (1988), What Are the Costs of Excessive Deficits?" in National Bureau of Economic Research Macroeconomics Annual 1988, ed. Stanley Fischer (Cambridge, Mass: MIT Press), pp.63-98.

analyses focus on rights and obligations of different individuals which can not be determined in conclusive manner.
A group of economists opposed reducing the projected surpluses to any significant extent, argued that additional saving was desirable to ease the burden on current and future generations would face from the post-2020 budget challenge[22].

Although popular economic stance was that the tax cuts and transfer payments generally reduce national saving, this conclusion may not hold for tax cuts that increase the reward for private saving (or reduce the penalty the current tax system imposes on saving). These proposals was estimated to boost private saving, which could offset the decline in government saving.

Many tax-cut proposals, such as reducing income tax rates increased the after-tax return to saving to the little extent. Other proposals had greater impact. Some proposals was expected to reduce the surplus by replacing the income tax with a consumption tax, setting the consumption tax rate below the level that would replace current revenues. Although reducing revenue turned to consumption tax and suggested caution in estimating the magnitude of any increase. An increase in national saving was expected to be more likely if such reforms were implemented on a revenue-neutral basis.

Democrats proposed a different approach that offered a tax cut, with the condition that individuals place the funds in an individual retirement saving account. President Clinton proposed, in his 2000 budget speech, that tax cuts of this type be used to fund a system of Universal savings accounts.

National saving became vulnerable because of the Tax cuts strategy to reduce the surplus that funded individual savings accounts. Current workers would receive the tax cuts, while future generations might bear part of the future tax increases and spending cuts necessitated by the reduction in the surpluses.

CBO in 1998 analyzed two things: 1) the relative worth of private saving in individual accounts; 2) government's saving through budget surpluses. Individuals were free to make their choices and hence their account expected to provide greater personal freedom. Individuals were not necessarily prepared to make these choices. In surveys cited by levitt (1998) and Diamond (1997), many Americans express unfamiliarity with the benefits of diversification, the relationship of bond prices to interest rates, and the differences between stocks and bonds. To reduce the problems posed by limited knowledge, individual portfolio choice would probably be restricted to some extent. Supporters also argue that the introduction of individual accounts would spur individuals to learn more about portfolio choice[23].

With budget surpluses, the government could branch out risk, particularly through generations. Budget surpluses might pose greater political risk because the allocation of

[22] Passell, Peter, "Not So Fast: Here Comes the Budget Crunch," New York Times, January 11, 1998, p. WK3
[23] Levitt, Arthur, "Before We Reinvent Social Security" Washington Post, November, 16, 1998, p. A25.

the future tax reductions or spending increases permitted by the surpluses would depend on political decisions that could not be predicted[24].
Individual accounts would have significant administrative costs unlike the budget surplus. Mitchell (1998) and Diamond (1997) observe that administrative costs consume 10 percent of returns for many private saving. Costs might be reduced to some extent if individuals were limited to a few standardized portfolio options[25].

Feldstein and Samwick cautioned about the decrease in national saving if Congress and the president adopted some form of tax cuts or spending increases. Because individual accounts would get reduced if any attempt were made to intact the surplus. However, possibility to avoid this outcome by imposing constitutional or other institutional restrictions that ruled out future backsliding[26].

Another way to reduce the surpluses was debated that suggested to increase the government's purchases of goods and services. Many forms of government purchases, such as Medicare spending, were essentially current consumption. Increases in government consumption raise issues similar to those posed by transfer payments or tax cuts that increase private consumption. The choice between private and government consumption were depended upon how effectively each type of consumption satisfies the preferences of individuals.

Future output may be increased through government purchases of education, public infrastructure, and health care for workforce. This type of investment is desirable provided it corrects market failure that facilitates a higher return than private investment. The data and results of the adopted strategies show that the mix of tux cut and individual savings and government purchases produced better results on the overall economic growth, on human development indicators and even on defense spending.

Conclusion

One aspect was evident from the data gathered through various sources that the issue of budget surplus was thoroughly debated in Congress and in presidential camp. Proposals were evaluated from welfare economy's point of view and from pure economic growth's point of view. Policy makers adopted a combination of economic events and policy changes that resulted in the surplus. If the policies of 1999s were continued the surplus was also expected to continue. This was also seen that the tax cuts and spending increases reduced the national saving and lowered output later on. The policy makers correctly pointed out the role of value judgment about the needs, rights, and obligations of the different generations to assess the individuals' behavior on saving.

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[24] Dionne, E.J., "Budget Deal Is a Political Classic", Washington Post, August 1, 1997, p. A21.
[25] Mitchell, Olivia S. " Administrative Costs in Public and Private Retirement System" in Privatizing Social Security, ed. Martin Feldstein, Chicago: University of Chicago Press, pp. 403-52.
[26] Feldstein & Samwick, "Potential Effects of Two Percent Personal Retirement Accounts", Tax Notes, May 4, 1998, pp. 615-620.