BY RUDOLPH PENNER

"The surplus is out of control" complains Bill Archer, Chairman of the House Ways and Means Committee.

Indeed. In January 1993, the Congressional Budget Office projected a budget deficit of $357 billion for the 1998 fiscal year. The actual outcome was a surplus of $69 billion, the first surplus since Richard Nixon was in the White House. About $130 billion of the difference is the result of changes in spending and tax policy. The rest ($296 billion) was what economists embarrassingly call a "forecasting error."

The CBO, now playing catch-up, continues to add to its projections of future excess. In March, it forecast surpluses of $273 billion in 2005 and $495 billion in 2010, provided discretionary spending grows at the same rate as inflation. And in light of the ebullience of the economy, it is very likely that the CBO will again add to its surplus estimates when it next reports in July.

WHERE DID THE SURPLUS COME FROM?

Every budget forecast is built on assumptions that don't prove correct. When the forecast is on target, it's usually the lucky result of having the errors offset each other. But in the past seven years, the errors have almost all gone in one direction – and the result has been gargantuan misses on the side of pessimism.

In the late 1990s, revenues began to grow much faster than GDP. In the four-year period 1995-98, personal income taxes grew at an especially rapid rate, propelled partly by the capital gains bonanza related to the irrational exuberance of the stock market. Tax payments by the very rich also soared, a good chunk of which amounted to a levy on Wall Street bonuses.

The 1993 increase in the top tax bracket added to the tax revenues extracted from exploding incomes at the top – a consequence that did not fit well into the worldview of supply-side economists. By 1998, the top 1.6 percent of income-tax payers – those with earnings over $200,000 – were responsible for an astonishing 39.8 percent of tax collections. All told, personal income taxes rose from 7.8 to 9.6 percent of GDP between 1994 and 1998, while total tax revenues rose from 18.1 to 19.9 percent of GDP.

Last year, the pace of collections cooled a bit: revenues grew at about the same rate as the economy. But real GDP growth remained well above 4 percent, astounding the many forecasters who had expected a significant slowdown. After all, expansions are supposed

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to begin rapidly and then taper off. But this Goldilocks economy has been accelerating since the mid-90s.

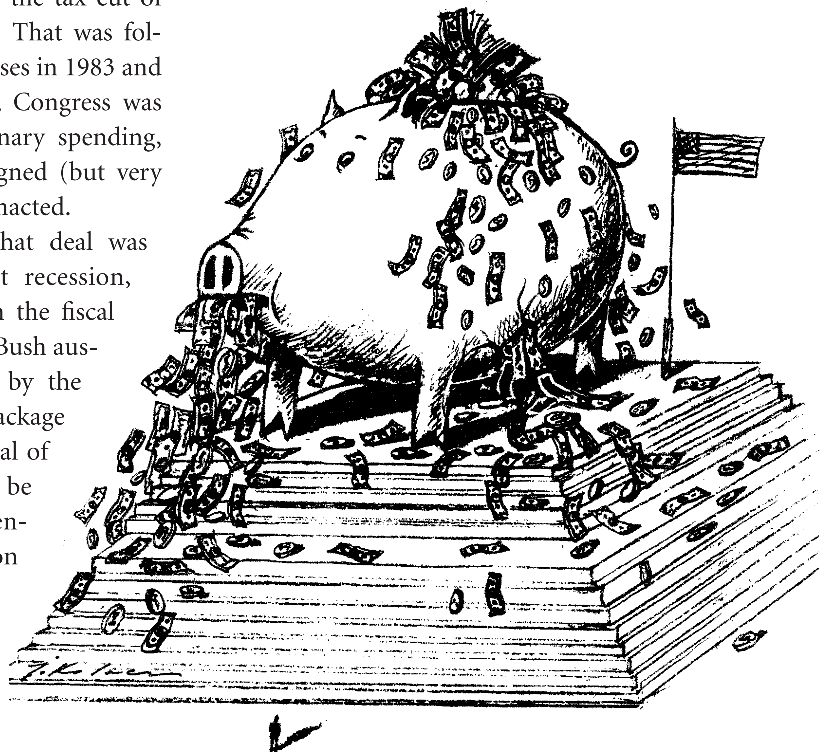
The CBO was also surprised by a reduction in the rate of growth of Medicare costs. In early 1993, it projected an annual growth rate of 12.1 percent for the following five years. Yet the actual annual growth rate of the medical insurance program for the elderly and disabled was only 8.1 percent. And, in 1999, Medicare costs declined – that's right, declined – for the first time in the history of the program. It seems that cost-saving measures, passed as part of the budget agreement of 1997, imposed much more restraint than anticipated.

Although the surplus surprised forecasters, it is important to emphasize that it would not exist were it not for important policy changes. Some very brave legislators spent much of the 1980s and early 1990s raising taxes and restraining spending – unpleasant work for politicians. In 1982, the tax cut of 1981 was substantially pared. That was followed by significant tax increases in 1983 and 1984. Throughout the 1980s, Congress was tough on domestic discretionary spending, and in 1990, the much maligned (but very large) Bush budget deal was enacted.

The positive impact of that deal was obscured by the subsequent recession, but it played a major role in the fiscal successes of recent years. The Bush austerity package was followed by the somewhat smaller Clinton package in 1993 and by the budget deal of 1997, which was expected to be small but had the aforementioned serendipitous impact on Medicare. Note, too, that the end of the cold war had an important beneficial effect: defense spending fell sharply relative to GDP after the transitory surge linked to Operation Desert Storm.

Demography also played an important role in balancing the books. Start with the reality that, separating out interest payments on the debt, more than half of all civilian spending goes to people over 65. Social Security is now the government's largest program, having overtaken defense in 1993. Medicare spending will soon surpass defense, and Medicaid payments for long-term care (mostly of the elderly) have grown rapidly in recent decades. Civil service and military pensions are also significant, while those elderly who are impoverished absorb a significant portion of welfare spending.

Yet, in recent years, demographic pressures on the budget have eased because the people born during the Great Depression have begun retiring, and there simply are not many of them. The bad news here, of course, is that the birth trough of the Depression was followed



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by the baby boom of the late-1940s and 1950s. And as the boomers start retiring in large numbers after 2010, surpluses will begin to decline relative to GDP. Eventually, then, there will again be deficits as far as the eye can see, unless programs for the elderly are radically reformed or taxes are raised to European levels.

HOW WILL THE SURPLUS BE USED?

Politicians have not yet become accustomed to a world of large surpluses. Moreover, it seems that as soon as they develop a plan for allocating the surplus, the CBO raises the surplus estimates yet again. Thus, we have not yet observed a political equilibrium around surpluses; that makes policy forecasting difficult.

The cumulative surplus now projected for the period 2001-10 is about $3.2 trillion, $2.3 trillion of which is dedicated to the Social Security trust fund. These sound like huge sums, sufficient to satisfy the spending dreams of the most profligate politician while leaving room to pay off a large portion of the $3.5 trillion publically held government debt. But a trillion dollars doesn't go very far these days: the cumulative surplus amounts to just 2.5 percent of GDP expected over the period.

To put that amount in perspective, remember that the ratio of government revenues to GDP rose by 1.8 percentage points between 1994 and 1998. So if this ratio falls back to what it was, the consequent increase in the interest cost of the national debt would be sufficient to eliminate most of the surplus.

Assuming that revenues come in as projected, both the Congress and the two presidential candidates hope to use a hefty chunk to repay the national debt. More precisely, the notion has taken root that it would be good to devote the entire surplus in the Social Security trust fund to that end. The nobility of goal is somewhat sullied, however, because its pursuit is justified by rhetoric that implies that Social Security benefits will be less secure if the goal is not accomplished. And that is mostly nonsense.

First, there is no direct legal or economic link between how the trust-fund surplus is used and the probability that promised benefits will be paid. In the first instance, the trust-fund surplus will be used to purchase securities from the United States Treasury. The Treasury can use the money that it receives either to repay some of the national debt or to finance a deficit in the non-Social Security operations of the government. But eventually the money will have to be given back to the trust fund to finance future benefits. This must occur, regardless of how the Treasury uses the cash in the interim.

The only impact on the probability that future benefits will actually be paid is indirect. If the trust-fund surplus is used to redeem debt that is now in the hands of the public, the interest bill facing the government will be lower in the future. In addition, the economy is likely to grow a bit faster because

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the reduction in government debt will release resources that can be used to finance private investment. Both the reduced interest costs and the added growth would make promised Social Security benefits more affordable – but, then, they would also make defense, tax cuts, highways and assistance to poor children more affordable.

Hence, there is no assurance that the reward from saving the Social Security surplus will be spent on Social Security – nor is there any compelling reason that it should be. Indeed, it is hard to argue that an ever-increasing share of the nation's wealth should be devoted to providing higher incomes to the relatively affluent elderly, so that they can enjoy ever-longer retirements.

But will the goal of using the entire Social Security surplus to redeem debt be achieved? It seems unlikely for several reasons. First, the political pressures favoring spending increases and tax cuts are now so powerful that it is doubtful they can be satisfied using only the resources provided by the surplus outside the Social Security trust fund – what insiders call the "on budget" surplus. The CBO's projections of that surplus assume discretionary spending will be held constant in real terms, a highly unlikely situation. There is a broad consensus that defense spending must be increased after a long drought, and the Congress seems in no mood to be stingy with regard to civilian spending.

In fact, the Congress went on a discretionary spending spree last year that largely went unnoticed because it was obscured by a host of budget gimmicks. These primarily involved artificial delays in spending in the 2000 fiscal year, so much of the budgetary impact will not show up until early in 2001. The Pentagon was also pressured to use some of its appropriation quickly so that the spending appeared in 1999 instead of 2000. And some agricultural spending was redefined as an entitlement, so that discretionary spending would not appear to be so bloated.

Adjusting for these artificial changes in the timing of spending, the real increase in spending for 2000 will be more than 5.5 percent. One must go back to the Reagan defense buildup of the mid-80s to find an increase of comparable magnitude and back to the Vietnam defense buildup to find anything much bigger. It would take an extreme swing toward stringency to freeze spending now in real terms. Indeed, even if discretionary spending grows only at the rate of GDP almost all the surplus outside of Social Security will disappear by 2010.

In addition to increasing discretionary spending, Congress seems determined to increase entitlement spending as well. A prescription drug benefit in Medicare is likely to pass without offsetting savings, and the elimination of the retirement test in Social Security will add some billions to spending over the next few years. Both parties also want to cut taxes, with wide agreement that the marriage penalty should be eased. Bush is eager to cut marginal tax rates as well, while Gore is proposing a plethora of tax credits in lieu of targeted spending increases.

Many analysts hope that the desire to save the Social Security surplus will restrain spending increases and tax cuts. But the budget rule requiring that this surplus be saved effectively requires that the budget for the non-Social Security part of the government must stay in balance. And that obligation contains the seeds of its own destruction.

The problem is that we cannot forecast the on-budget balance very accurately: projections of next year's budget balance can easily change by $100 billion over six months. But given the political climate, any unexpected additions to the projected on-budget surplus

are likely to be used up quickly for tax cuts and spending increases. Conversely, it will be politically impossible for the Congress to raise taxes or to cut spending fast enough to keep up when projections start deteriorating. Just look back: the Gramm-Rudman law of 1985 that attempted to balance the overall budget was jettisoned in 1990 as deficit forecasts became more pessimistic.

Consequently, there is little hope that we shall actually use the entire Social Security surplus for retiring debt over the long run. Nevertheless, the immediate fiscal outlook is so good that it seems reasonable to assume that some surplus will remain and that much debt will be retired. In fact, there is a very good chance that by 2010 the debt to GDP ratio will fall to levels considerably lower than the previous post-World War II low of 23.8 percent, achieved in 1974. The combined public debt holdings of the Federal Reserve, foreigners, and state and local governments about equal this portion of GDP, so it is easy to foresee a shortage of public debt as a vehicle for conservative private investment.

HOW SHOULD THE SURPLUS BE USED?

It seems safe to assume that the overall budget surplus will last for a good many years, even though it may be reduced to levels below the surplus in the Social Security trust fund. At this time, it makes sense to be particularly cautious in formulating budget policy. After all, the forecast that Social Security and Medicare spending will rise rapidly after 2010 is more certain than most budget forecasts because the people who have their hands out are already living among us.

In the longer run, the spending increase will be very large, and without reforms or major tax increases there is a risk of a debt explosion. That suggests it would be prudent to repay a high portion of the public debt while we can in order to prepare for the burdens to come.

Retiring the whole debt may not be advisable, because the investment of any remaining surpluses in private financial markets could cause some political mischief. But it would be good to break the post-World War II record and get the debt considerably below 25 percent of GDP. Once we are certain that we can accomplish that goal, we can have some fun cutting taxes and increasing spending. However, the goal is unlikely to be achieved before the end of 2004.

Alternatively, some of the surplus could be used to ease the transition to funding public pensions through individual accounts. Tax cuts could compensate workers during the period in which they would be obligated to finance both benefits for those already retired and their own future benefits.

If the growth of Social Security benefits could be slowed in return for establishing individual accounts, I would become an enthusiastic advocate for using much of the rest of the surplus for tax cuts. However, it is difficult to imagine that we shall accomplish this any time soon. Regardless of who wins the White House, the current political outlook suggests that neither party will have a large enough majority in the House to implement any radical policy change.

Although the disposal of the surplus has become as politically contentious as reducing the earlier deficit, it is important to remember how lucky we are. We can carp all we want about the relative benefits of paying off the debt versus cutting taxes versus increasing spending, but it is like arguing over the choice between a chocolate cake and a hot fudge sundae. We spent most of the 1980s and early 90s forcing down the broccoli, and now it's a matter of choosing among desserts. M