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BUDGETING IN A SURPLUS ENVIRONMENT

For further information, please contact Jon Blondal at OECD Headquarters in Paris;
Facsimile: (33-1) 45 24 17 06 E-mail: jon.blondal@oecd.org

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La budgétisation en situation d’excédent

FOREWORD

A significant number of Member countries have moved (or are moving) from a situation of budget deficits to near balance or budget surplus. Budgetary rules have generally played an important role in achieving this transformation. Fiscal surpluses, however, pose new challenges for maintaining spending discipline as ministries and agencies may see the surpluses as a source of funds for new spending. This paper examines United States budget legislation and practices in achieving and maintaining surpluses. It was discussed at the 1999 annual meeting of Senior Budget Officials as part of the Public Management Committee's program of work on budgeting and financial management.

The report was prepared by Mr. Barry Anderson when he was Vice President of the Jefferson Consulting Group. Previously, the author was Assistant Director of the Office of Management and Budget. He is currently Deputy Director of the Congressional Budget Office. The report was edited by Jon Blondal of the OECD Public Management Service. Technical assistance was provided by Helene Leconte and Katherine Poinsard.

The views expressed are those of the author and do not commit or necessarily reflect those of governments of OECD Member countries. The report is published on the responsibility of the Secretary-General of the OECD.

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EXECUTIVE SUMMARY

In the 1980s, budget deficits in the US quickly grew to unprecedented nominal levels: over $200 billion annually, with most forecasts containing deficit estimates continuing at the $200 billion level for the foreseeable future -- or, "as far as the eye can see." In response to the high deficits, which were not dramatically reduced even in years with higher economic growth, the US Government began a series of ever-more-complicated changes to its budgetary legislation and practices whose objective was to decrease and eventually eliminate annual deficits. The primary changes to US budgetary legislation and practices during this period were:

- A series of one -- or two-year budget agreements between the Congress and the President, which generally specified limits on annually-appropriated discretionary spending, reductions in the rate of growth in mandatory, or entitlement spending, and increases in taxes and fees;

- The Gramm-Rudman-Hollings (G-R-H) Act of 1985 and an extended version of the Act in 1987, which specified declining deficit targets that were enforced (in the absence of legislation that met those targets) by uniform percentage reductions (referred to as sequestration) in selected mandatory and most discretionary spending programs; and,

- The Budget Enforcement Act (BEA) of 1990, which replaced the deficit targets of G-R-H with a more complicated series of limits on discretionary spending, constraints on new mandatory spending and tax cuts, and reforms in the process of budget accounting, particularly for government direct and guaranteed loan programs.

Despite this series of new legislation and practices, deficits in the US did not decline, and in fact reached an all-time nominal high of over $290 billion in fiscal year 1992.

The fiscal situations and subsequent government responses in many other OECD countries during this time were substantially different from what occurred in the US. High deficits in the early 1980s were common, but many countries were able to lower their deficits -- some in fact reaching surpluses -- by the late 1980s, many without having to resort to complicated new budget legislation or procedures. It was not uncommon during the late 1980s and early 1990s for many countries to question the ever-more- complicated, but apparently unsuccessful, US efforts to reduce deficits.

The fiscal situations in the US and in many other OECD countries changed dramatically as the 1990s progressed. In the US, the enactment of the Budget Enforcement Act (BEA) in November 1990 was soon followed, beginning in April 1991, by a period of strong economic growth that has continued to the present time. In addition, the government spending required to resolve the obligations that arose from deposit insurance for failed US savings-and-loans institutions was essentially completed in fiscal year 1992. The added revenues that resulted from the economic expansion and the lower growth in mandatory spending (especially in health care), along with the spending limits enacted in the 1990 BEA and the end of the savings-and-loans spending, dramatically reduce deficits. The limits on spending in the BEA were extended in 1993, and again in 1997, but the growth in revenues (and the decline in the growth of mandatory spending) was so strong as a result of the continued economic expansion that a surplus of $70 billion was attained in fiscal year 1998, and surpluses are forecasted for many years to come.

Meanwhile, many of the other OECD countries that had so successfully reduced deficits in the late 1980s and early 1990s found that their fiscal successes did not last. By the mid-1990s, deficits had returned and some countries began to question their budgetary processes.

In addition to the above trends, the approval of the Maastricht Treaty for a common European currency, the Euro, required European countries that wished to convert to the Euro meet the budgetary constraints imposed by the Treaty. Countries believed that the monetary union would promote greater economic growth and that the political costs of the budgetary constraints imposed by the Treaty would be more than compensated by the political gains of greater economic growth. The Treaty required that all countries begin to take action to lower their deficits to not more than 3 per cent of their GDP and to decrease their debt to not more than 60 per cent of GDP by fiscal year 1997. After having adopted the Euro, countries were required by the Treaty to maintain these targets over the business cycle or potentially be subjected to an increasingly severe set of sanctions. There are obvious similarities between the budgetary constraints and sanctions contained in the Maastricht Treaty and those imposed by the G-R-H legislation in the US, as the following table indicates:

	Maastricht	US	
Constraints		G-R-H	BEA
‣ Deficit limits..................	3 % of GDP over cycle	Nominal Targets	None
‣ Debt limits.....................	60 % of GDP over cycle	None	None
‣ Recession exception.......	Yes	Yes	Yes
‣ Spending targets............	None	None	Caps and PAYGO
Sanctions			
• First level......................	Moral Suasion	Moral Suasion	Moral Suasion
• Second level..................	Deposit with European Council is held, perhaps forfeited	Aggregate sequester of mandatory and discretionary spending	Detailed Sequester of category of spending where targets have been exceeded
• Third level....................	Expulsion?	None	None

Both Maastricht and G-R-H impose limits on deficits. Both specify exceptions for periods of recession. They have similar sanctions, starting with “moral suasion”, i.e., the power of the populace, the media, and other legislators to encourage adherence to the constraints, and continuing with broad-based sanctions that affect governments more in the aggregate than the BEA sanctions.

G-R-H’s constraints and sanctions did not produce the targeted decline in deficits. The reasons for this clearly include misestimates of the rate of economic growth. But just as important in explaining the problems with G-R-H is the nature of its constraints and sanctions. Aggregate deficits were usually affected more by economic and technical factors outside the control or influence of the political process than by annual legislation. Moreover, the size of the sequesters required to eliminate deficit increases caused by economic and technical factors was occasionally so large that the threat of sequester was not an effective deterrent to new spending legislation. G-R-H’s aggregate sequester sanctions impacted the entire political spectrum, from those who strongly supported G-R-H and fiscal restraints to those who worked to overturn it. Moreover, as a prerequisite to economic growth, deficit reduction was not truly embraced by the political spectrum until the 1992 presidential election. Before then, public opinion polls consistently reflected overwhelming support for balanced budgets, but that support dissipated when specific spending or revenue changes needed to achieve balance were proposed. Thus, moral suasion had limited effectiveness in the G-R-H period.

Although the rate of economic growth may have been a more important factor than the nature of G-R-H's constraints and sanctions, the BEA method is viewed as a more effective and equitable method of constraints and sanctions. The political process accepted the BEA's constraints on spending to a much greater degree than they accepted G-R-H's arithmetically determined annual reduction in deficits. In addition, the spending constrained by BEA was generally not influenced by economic and technical factors. Thus, there was much more of a willingness to abide by the constraints. In fact, the explicit targets helped create an atmosphere of reduced expectations, which eased the political costs of spending restraints. If the spending targets were threatened, moral suasion was a much more powerful sanction under BEA than it had been under G-R-H.

The similarities between the Maastricht and G-R-H constraints and sanctions may produce similar results. The experience and problems that some countries have already had in meeting the Maastricht constraints may encourage the European Community to consider BEA-like constraints and sanctions as an alternative to their current system.

Caps on Overall Discretionary Spending. Annually provided discretionary spending is limited by two simultaneously enforced caps: one on budget authority, which provides permission to spend; the other on outlays, which is the spending itself. Although funding for unforeseen natural disasters has pushed actual spending slightly above the caps for most years, the caps have been relatively effective in limiting discretionary spending; that is, the caps have generally forced trade-offs or compromises among programs that would not have been made in their absence. The effectiveness of these caps is not related to their redundancy, but rather to their enforcement mechanisms (see below) and to the long period to which they apply: 5 years.

PAYGO. Non-annually appropriated (or mandatory) spending programs and tax collections are very difficult to cap because they are greatly influenced by economic and demographic factors outside the context of legislation. Thus, a different control mechanism was created: expansions of non-annually appropriated spending and reductions in taxes are limited to the extent that they must be fully offset. These limits are called "PAYGO", which is short for pay as you go. Tax cuts may be offset by spending cuts, and spending increases may be offset by tax increases, but PAYGO prohibits any expansion of new benefits without appropriate offsets. Like the caps on overall discretionary spending, the effectiveness of the PAYGO rules is related to their enforcement mechanisms and to the long period to which they apply: 5 years.

Sequester Enforcement Mechanisms. The mechanism used to enforce the caps on annually provided spending and the PAYGO rules are called sequester. If the caps are exceeded or increases in spending and taxes covered by PAYGO are not fully offset, then after the Congress adjourns the US Office of Management and Budget is required to reduce funding by a uniform percentage for all annually-appropriated spending programs (for the caps) or for a select number of non-annually-appropriated spending programs (for PAYGO) until the excesses or net increases are eliminated. Taxes are not increased to offset the PAYGO excess; only select non-annually-appropriated spending programs are cut. The sequester process, although rarely used and never for large sums, is very effective in discouraging legislation from exceeding the caps or breaking the PAYGO limits. A similar sequester process was used to enforce the deficit targets (see below) of the Gramm-Rudman-Hollings law, but because the deficit targets eventually were far below actual deficits due to inaccurate (and uncontrollable) economic and technical forecasts, the threat of very large sequesters was ultimately not effective in restraining spending.

Baselines. The above rules, particularly the PAYGO rules, should be measured relative to a set of projections, or baselines, made independent of the political process. Independent baseline projections are required for fair estimates of the impacts of proposed legislation. Having baselines established by an independent, non-political agency, particularly one that does not report to the executive branch of government, is one way to promote objective baseline projections.

Shutdowns. In the winter of 1995 -- 1996, the inability of the Clinton Administration and the Congress to agree on what programs to fund within the discretionary spending caps for fiscal year 1996 led to an impasse where no funding at all was provided for several agencies. This absence of funding "shutdown" or closed several agencies, except for activities necessary to preserve life or property, for several weeks. In addition to different spending priorities, some of the debate revolved around the Clinton Administration's efforts to expand the gross level of the caps on discretionary spending by offsetting the increases with cuts in mandatory spending (PAYGO) programs. Partial, short-term government shutdowns have also occurred in other years, but they are not an intrinsic part of the US budgeting procedures. They do demonstrate the powers of the caps to force political compromise, even if the process to reach that compromise is an inefficient one.

The growth in the US economy is primarily responsible for eliminating the US Government's deficits. Continued growth promises surpluses over the near future. *Budgetary laws and practices have clearly helped eliminate deficits and they are absolutely needed to keep the surpluses from being spent away*. Central budget offices will receive little help or rewards for policing budgetary rules, but the rules' effectiveness in helping to improve fiscal policies and the economy makes the effort worthwhile.

SURPLUS BUDGETING IN THE UNITED STATES
OR STOP ME BEFORE I SPEND AGAIN

In fiscal year 1998, the United States Government had its first surplus in almost 30 years. Moreover, surpluses are more confidently forecasted than ever before for the foreseeable future. New budget legislation and the implementation of that legislation profoundly changed US budgeting practices in the late 1980s and 1990s. This paper examines US budget legislation and practices in achieving and maintaining surpluses with the hope that this examination may be useful to other countries with similar circumstances.

I. Recent Budget History, *or* Damn the Deficits: Full Spend Ahead

In the 1980s, budget deficits in the US quickly grew to unprecedented nominal levels: over $200 billion annually, with most forecasts containing deficit estimates continuing at the $200 billion level for the foreseeable future -- or, "as far as the eye can see." In response to the high deficits, which were not dramatically reduced even in years with higher economic growth, the US Government began a series of ever-more-complicated changes to its budgetary legislation and practices whose objective was to decrease and eventually eliminate annual deficits. The primary changes to US budgetary legislation and practices during this period were:

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There are obvious similarities between the budgetary constraints and sanctions contained in the Maastricht Treaty and those imposed by the G-R-H legislation in the US, as Table 1 indicates.

Table 1. Budgetary Constraints and Sanctions
Maastricht and US

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The similarities between the Maastricht and G-R-H constraints and sanctions may produce similar results. The experience and problems that some countries have already had in meeting the Maastricht constraints may encourage the European Community to consider BEA-like constraints and sanctions as an alternative to their current system.

II. The Importance of Economic Growth, *or* “It’s the Economy, Stupid”

US budgetary legislation, particularly the BEA, and revised practices have played an important part in helping the US reach a surplus. Nevertheless, the part played by new legislation and practices is secondary when compared to the importance of economic growth.

Economic growth’s importance can be seen from reviewing the BEA limits, Clinton proposals, and actual spending and revenues from 1993 to 1998 listed in Table 2. Deficits declined primarily because the growing economy expanded revenues and limited the growth in mandatory spending. Adherence to the discretionary caps, and limits on new mandatory spending and tax cuts undoubtedly helped but not as much as the growing economy.

A brief explanation of the data in Table 2 is illuminating. Although an economic expansion had been taking place for almost two years when President Clinton’s first budget proposal, *A Vision of Change for America*, was released, the President’s budget did not recognize the growth in economy. Instead, his budget proposed to break the limits of discretionary spending that had been put in place in the 1990 BEA in order to finance new "stimulus and investment" spending. Congress did not enact the President's request for new spending, and in fact passed legislation that extended the limits on discretionary spending through fiscal year 1998.

Table 2

Spending and Revenues from 1993 to 1998
The BEA limits, Clinton proposals, and actual

	Fiscal Years					
	1993	**1994**	**1995**	**1996**	**1997**	**1998**
Non-Defense Discretionary Spending *						
BEA Limits	242	N/A	N/A	N/A	N/A	286
Clinton 1993 Proposals	262	270	282	293	302	313
Actuals	248	261	272	268	277	285
Total Discretionary Spending *						
BEA Limits	534	537	539	547	547	548
Clinton 1993 Proposals	556	548	555	558	552	566
Actuals	541	544	545	534	549	555
Mandatory Spending						
January 1993 Estimates	724	765	795	843	920	996
Clinton 1993 Proposals	717	753	782	812	868	923
Actuals	670	715	738	785	809	855
Total Spending						
January 1993 Estimates	1475	1523	1578	1645	1745	1843
Clinton 1993 Proposals	1475	1513	1565	1613	1678	1767
Actuals	1409	1462	1516	1561	1601	1653
Revenues						
January 1993 Estimates	1148	1230	1306	1379	1440	1523
Clinton 1993 Proposals	1143	1251	1323	1408	1471	1526
Actuals	1154	1259	1352	1453	1579	1723
Deficits/Surpluses						
January 1993 Estimates	-327	-270	-230	-266	-305	-320
Clinton 1993 Proposals	-332	-262	-242	-205	-206	-241
Actuals	-255	-203	-164	-107	- 22	70

* Outlays. BEA limits are not adjusted for special exceptions, such as emergencies and Desert Storm.
N/A: not available. There were no specific non-defense discretionary caps for 1994-1997.

Sources: BEA Limits, January 1993, estimates and Actuals: OMB.
Clinton 1993 Proposals: *A Vision of Change for America,* February, 1993.

Table 2 shows that actual total discretionary spending slightly exceeded the limits established in the BEA for every year between 1993 and 1998 except 1996. This is mostly because of spending for natural disasters and other unexpected emergencies. However, actual total discretionary spending was far below

President Clinton's February 1993 proposals despite the fact that President Clinton used cuts in defense spending to pay for some of his increases in non-defense spending. (The BEA did not establish separate caps for defense or non-defense spending in 1994-1997).

Most importantly, Table 2 shows that revenues far exceeded the January 1993 BEA estimates and President Clinton's February 1993 proposals. Some of the unexpected revenue growth resulted from an extraordinary increase in equity prices, but this too is related to the growth of the economy. Likewise, Table 2 shows that mandatory spending, which was not capped but limited by the pay-as-you-go rules (see PAYGO below), was far below the 1993 estimates and proposals.

The data in Table 3 further supports this conclusion. Table 3 differentiates the changes between President Clinton's proposed annual budgets and actual spending, revenues, and deficits over the 1994-1998 period. It indicates that none of the reduction in deficits from President Clinton's annual proposals resulted from enacted legislation. In fact, legislation **increased** deficits slightly over the five year period, mostly for emergencies. Adherence to the BEA rules helped by limiting the impact of new legislation, but all of the reduction in the deficit resulted from economic and technical changes. (Technical changes are those that cannot be easily attributed to enacted legislation or the difference between economic assumptions and actual economic statistics. The ability to attribute changes to economic or technical explanations is frequently arbitrary, but the impact of legislation can usually be clearly measured).

Table 3

Legislative, Economic, and Technical Changes in Proposed Budgets

(Total Changes from Specific Year Budget Proposals to actuals, in Billions of Dollars)

	1994 Budget	**1995 Budget**	**1996 Budget**	**1997 Budget**	**1998 Budget**	**Total**
Total Spending "-" **equals decrease in deficit**						
Legislation	-1	6	-4	5	6	12
Economic	-10	14	-24	4	-9	-26
Technical	-43	-27	-25	-43	-31	-169
Total	-55	-7	-53	-34	-35	-184
Revenues "-" **equals decrease in deficit**						
Legislation	-9	-13	3	6	-3	-16
Economic	6	16	29	0	39	89
Technical	10	-9	5	78	120	203
Total	7	-6	37	84	155	276
Deficits "-" **equals decrease in deficit**						
Legislation	8	18	-6	-1	9	27
Economic	-16	-1	-53	4	-48	-115
Technical	-53	-18	-30	-121	-151	-372
Total	-61	-1	-89	-118	-190	-459

Source: OMB data

In other words, the growth in the economy produced the surplus through the expansion of revenues and the decline in the growth of mandatory spending. The limits on spending were generally adhered to, but they did not explain the decline in deficits. Ironically, President Clinton's 1992 campaign slogan "It's the Economy, Stupid" supports this explanation.

The US experience indicates that economic growth is the prerequisite for achieving balance, but budget rules (legislation and practices) clearly help by making it possible for an expanding economy to restore fiscal health. The current US budget environment demonstrates that there are limitless ways to eliminate a surplus through new spending or tax cuts. The US budget rules do not preclude new spending or tax cuts; they just require that any new (hopefully, high-return) investment ideas -- either spending or tax cuts -- be paid for by cutting an equivalent amount of other (hopefully, low or no return) spending. The rules merely force the proponents of new spending or tax cuts to find low return programs to cut.

III. The US Really Is in Surplus, *or* the Social Security "Trust Fund" Is a Sham

This paper uses the **unified** government spending and revenue concept; that is, a measure that takes **all** Federal spending and taxes into account, including those for so-called "trust fund" or "off-budget" accounts. Some in the US claim the unified concept is not the best measure for determining whether the US Government is in deficit or surplus. They claim the net impacts of the Social Security Trust Fund should be deleted from the rest of Federal spending and revenues to measure the deficit or surplus. The Old Age, Survivor's, and Disability Insurance Fund, commonly known as Social Security, is the US Government's major program to provide basic retirement benefits to the elderly, the disabled, and the survivors of those who die before retirement. It is funded primarily by payroll taxes, but also by income taxes on Social Security benefits for those Social Security recipients with higher incomes, and by interest paid on special, non-marketable US Treasury securities held by the Social Security Trust Fund. Social Security is currently collecting more in taxes than it is paying out by an amount that exceeds the unified surplus. This means that the Federal Government's operations excluding Social Security are currently in deficit and they are forecasted to remain so until fiscal year 2001.

Measures of Federal Government activity excluding Social Security may have value in some context, but the unified concept is clearly the best and only appropriate measure for assessing the impact of Federal activity on the economy, and vice versa. Similarly, the unified concept is also the best to assess the appropriateness of budget rules to help produce budget outcomes.

Calls for exclusion of Social Security from total Federal Government spending and taxes come from a misunderstanding of the nature of the Social Security program -- a misunderstanding that is sometimes fostered by the US Government itself, by the pronouncements and promises of public officials, and by the language used in official Social Security documents. (See *Your Personal Earnings and Benefit Estimate Statement* from the Social Security Administration, attached.) Social Security should be included in the Federal budget because it is a defined benefit, pay-as-you-go, inter-generational, income transfer program that by its very nature is inherently governmental.

Although Social Security is inherently governmental and clearly should be included with all other Federal spending and taxes, it could be replaced with a private, non-governmental retirement system. Such a system would change the fundamental nature of the current Social Security system. Instead of providing benefits established and guaranteed by the Federal Government, the benefits of a new, private retirement system would be a function of the level of investments and the returns earned by those investments. Depending on the earnings of their investments, some retirees could do very well while others might have little or nothing. In other words, this would convert Social Security from a defined benefit program, where benefits are established by the Government, to a defined contribution program, where the Government's payments into each individual's account are established, but the benefits are not. Social Security was created largely to provide a "social safety net" for the elderly; privatization could alter that goal, but this would be a very big shift in US social policy.

Alternatively, the social safety net purposes of Social Security could be retained, but combined with Government incentives for individuals to save privately for retirement. A program that provides tax incentives or grants to encourage individuals to establish a defined contribution retirement fund can be combined with some version of the current defined benefit Social Security system to make sure that no individual's retirement income falls below a minimal level. Over the past twenty-five years, the United Kingdom expanded its defined benefit social insurance plan to one with both defined benefit and defined contribution aspects.

Other proposals seek to increase the "earnings" on the "contributions" to Social Security by having the Federal Government invest a portion of them in equities. Despite the fact that the returns on US equities have historically been much higher than the returns on Treasury securities, this scheme will not necessarily provide additional real resources for the Federal Government to pay the benefits for future Social Security retirees. This is so because in order to make these equity purchases, the Federal Government will have to borrow more from the public to replace the amounts the Government borrowed from Social Security. Thus, net national savings are not increased and there is no reason to expect that the economy will perform better as a result of the Federal Government issuing new debt to finance the purchase of equities. In addition, the real risk of political interference into the selection of these equities further discredits political promises of additional future real resources.

The contrast between Norway and the rest of the world (including the United States) in investing "surpluses" is revealing. Norway has a current surplus, and it has virtually no debt. To help it set aside real resources for its future social insurance obligations, Norway is, in essence, selling oil and buying securities world-wide with the proceeds after paying for current government operations. The Norwegian Government chooses to invest much of its surplus outside of Norway not only because its surpluses are so large, but also because they can earn better returns on international investments than they can on any remaining domestic investments.

The United States may have a surplus currently, but it also has a $3.7 trillion debt. Moreover, as stated above, Social Security's investment in US equities is really nothing more than a swap of one type of financial security (Treasury debt) for another (corporate equities), but with no net gain to the economy. If the proponents of increasing Treasury debt to pay for corporate equities really believe that such transactions would help the Government meet its long term obligations, then their policy should be applied much more broadly than just to a small portion of the Social Security Trust Fund. That is, if the arbitrage of Treasuries for equities makes sense for Social Security, why doesn't it make sense on a much larger scale. So far the debate over expanding the Federal Government's ownership of the means of production has been limited to a portion of the Social Security surplus, but it could grow once the first step is taken.

These examples of proposals to "fix" Social Security call to mind the natural tendency of governments to hide the inherently governmental nature of taxes and defined benefits. This tendency needs to be monitored constantly to ensure that governments report on their total activities honestly and accurately.

The Social Security System

- Social Security was originally designed as -- and still is -- a defined benefit program. As inter-generational and income transfer aspects were quickly added to it, it also became a pay-as-you-go system.

  - Defined Benefit: The benefits paid to every Social Security recipient are defined (or determined) in Federal legislation. They are not a function of the amount of taxes paid by working Americans, nor are they a function of the earnings of the so-called balances in the Social Security Trust Fund. Benefits can, and have been, increased and decreased in the past and undoubtedly will be changed in the future.

  - Pay as you go: The Social Security Trust Fund is really no more than an accounting device designed to help policy makers assess current levels of Social Security benefits and taxes. It does not really invest current income that is in excess of current obligations for future use. As stated above, income in excess of current obligations is placed into special, non-marketable US Treasury securities, but these securities are no more than I.O.U.s which the Government owes to itself. As it evolved, the Social Security Trust Fund was not constructed to accumulate real resources (and earnings on those resources) in anticipation of future payments. Instead, it was operated so that current benefits would be paid out of current receipts – in other words, pay as you go. The initial recipients of Social Security benefits were paid from taxes paid by those working at the time, not from the taxes (and earnings on balances) that the original recipients had paid previously. Because Social Security was operated as a pay-as-you-go system, it is not a trust fund in the common usage of the word. The misuse of the term “trust fund”, when describing Social Security causes much confusion to the American public.

  - Inter-generational: As a pay-as-you-go system, Social Security in effect transfers resources from the generation(s) currently working to the generation(s) currently retired. There is nothing particularly unusual about this. Most programs designed to help the elderly and all designed to help the young are inter-generational because the benefits are paid from taxes largely collected from non-elderly and non-young. The perception of many current recipients of Social Security is that they are entitled to benefits that reflect the returns on the money they paid into Social Security. However, this perception does not take into account that the money they paid in was disbursed as soon as they paid it to those retired at the time.

  - Income Transfer: Originally, Social Security benefits were established using a formula tied to the taxes paid into Social Security. As time has progressed, legislation has revised the formula so that lower income people get proportionately more Social Security retirement benefits than middle and higher income people. The disproportionate nature of benefits, which minimizes the returns for single individuals with higher earnings, has prompted a significant public debate as to whether Social Security is a good investment for all workers.

- Social Security as currently organized is inherently governmental. The revenues it collects are taxes -- not “contributions” as some Government publications have called them -- that are required as a direct result of the use of the Federal Government’s sovereign power to levy taxes. The benefits Social Security pays are entirely a function of what Congress and the President say they ought to be. They can be changed at any time, and Social Security beneficiaries cannot sue to collect benefits not specified in current legislation no matter how large their “contributions” and so-called “earnings”, and no matter how much money is in the Social Security Trust Fund accounting device.

IV. US Budget Procedures to Obtain and Preserve Surpluses, *or* So Much Debt, So Little Time

Many in the US, including some in the US Government itself, confuse the public by inappropriately excluding Social Security activities from Federal spending and revenues. As stated above, the unified concept of Federal activity, which measures all Federal spending and revenues, is clearly the best and only appropriate measure for assessing the impact of Federal activity on the economy, and vice versa. Using the unified concept, the US budget is currently in surplus and should remain so for the next several years. During this period of surpluses, the US Government will begin to pay down its $3.7 trillion of debt held by the public.

This period of surpluses is forecasted to be relatively short-lived, however. In the absence of reductions in benefits to future retirees or tax increases, spending on Social Security and health benefits for the baby boom generation is forecasted to bring back deficits sometime after the next decade or so. Forecasts of the size of future surpluses and the year that deficits return vary considerably depending on assumptions concerning the economy and political decisions on spending and taxes. Despite the variability, there is virtual certainty that deficits will return sometime in the future, and this certainty combined with the economic advantages of paying down the debt supports the importance of extending current budgetary laws and practices as a means to retain surpluses.

Listed below are various US budgetary legal provisions and practices. Some are much more important than others. Some have been tried and discarded, and some are in place but of little value. In fact, the first eight items listed below provided virtually all of the structure used in the US to restrain spending and tax cuts. A review of these procedures should be of value to countries facing budgetary problems similar to those recently faced by the US

- **Caps on Overall Discretionary Spending**. Annually provided discretionary spending is limited by two simultaneously enforced caps: one on budget authority, which provides permission to spend; the other on outlays, which is the spending itself. Although funding for unforeseen natural disasters has pushed actual spending slightly above the caps for most years, the caps have been relatively effective in limiting discretionary spending; that is, the caps have generally forced trade-offs or compromises among programs that would not have been made in their absence. The effectiveness of these caps is not related to their redundancy, but rather to their enforcement mechanisms (see below) and to the long period to which they apply: 5 years.

- **PAYGO**. Non-annually appropriated (or mandatory) spending programs and tax collections are very difficult to cap because they are greatly influenced by economic and demographic factors outside the context of legislation. Thus, a different control mechanism was created: expansions of non-annually appropriated spending and reductions in taxes are limited to the extent that they must be fully offset. These limits are called “PAYGO”, which is short for pay as you go. Tax cuts may be offset by spending cuts, and spending increases may be offset by tax increases, but PAYGO prohibits any expansion of new benefits without appropriate offsets. Like the caps on overall discretionary spending, the effectiveness of the PAYGO rules is related to their enforcement mechanisms and to the long period to which they apply: 5 years.

- **Sequester Enforcement Mechanisms**. The mechanism used to enforce the caps on annually provided spending and the PAYGO rules are called sequester. If the caps are exceeded or increases in spending and taxes covered by PAYGO are not fully offset, then after the Congress adjourns the US Office of Management and Budget is required to reduce funding by a uniform percentage for all annually-appropriated spending programs (for the caps) or for a select number of non-annually-appropriated spending programs (for PAYGO) until the excesses or net increases are eliminated. Taxes are not increased to offset the PAYGO excess; only select non-annually-appropriated spending programs are cut. The sequester process, although rarely used and never for large sums, is very effective in discouraging legislation from exceeding the caps or breaking the PAYGO limits. A similar sequester process was used to enforce the deficit targets (see below) of the Gramm-Rudman-Hollings law, but because the deficit targets eventually were far below actual deficits due to inaccurate (and uncontrollable) economic and technical forecasts, the threat of very large sequesters was ultimately not effective in restraining spending.

- **The Unified Budget Concept**. All of the above rules should be applied to the unified budget concept, which includes all governmental spending and taxes, even those in "trust funds" or for capital equipment. However, in the US currently the above rules do not apply to accounts that have been placed "off-budget" by legislation (Social Security and the Post Office). Such legislation has been popular to give the appearance of special treatment for favored programs. But to be effective the rules need to apply to all government activities or new spending will shift to "off-budget" accounts, and the value of the mechanisms in providing fiscal constraints will be diminished. Despite Social Security's size (23 per cent of total spending), its "off-budget" status has not diminished the effectiveness of the BEA rules so far, mostly because of the political reluctance to take any action that would worsen the actuarial status of the Social Security Trust Fund.

- **Baselines**. The above rules, particularly the PAYGO rules, should be measured relative to a set of projections, or baselines, made independent of the political process. Independent baseline projections are required for fair estimates of the impacts of proposed legislation. Having baselines established by an independent, non-political agency, particularly one that does not report to the executive branch of government, is one way to promote objective baseline projections.

- **Dynamic Scoring**. Estimates of proposed policy changes generally should not take into account potential impacts on the economy at large. Such impacts, which are frequently called dynamic scoring, are virtually impossible to estimate accurately, and usually do not occur as a result of individual policy proposals, no matter how important they may seem to their proponents. Although fiscal constraints would be fatally weakened by changes in economic assumptions for proposed policy changes, this rule should not apply to demographic changes that may result from policy proposals.

- **Cash Budgeting**. Except for credit programs, cash budgeting should be used. Accrual accounting is too subjective and thus, too easy to influence by the political process. In addition, unlike any other entity, the federal government's financial condition is better explained by using cash concepts because of its unique types of assets and liabilities and its unique ability to tap credit markets. However, there is a benefit to using a form of accrual accounting for government asset sales, insurance, direct loan and loan guarantee programs if the projections for these programs can be made independently of the political process. The benefit of using accrual accounting for these programs results from the contingent liability nature of these programs that is not captured by cash budgeting.

- **Disasters**. If what constitutes a natural disaster can be objectively defined, and if spending is provided under the caps in advance of a disaster that is designed to avoid and/or mitigate the effects of disasters (such as fire roads in forests), then exceptions to the caps for natural disasters can help reinforce the adherence to the caps by not requiring unrealistic, last-minute cuts in programs for urgent, unforseen natural disasters.

The following rules are generally not important in the US system of budgetary control.

- **Shutdowns**. In the winter of 1995 - 1996, the inability of the Clinton Administration and the Congress to agree on what programs to fund within the discretionary spending caps for fiscal year 1996 led to an impasse where no funding at all was provided for several agencies. This absence of funding "shutdown" or closed several agencies, except for activities necessary to preserve life or property, for several weeks. In addition to different spending priorities, some of the debate revolved around the Clinton Administration's efforts to expand the gross level of the caps on discretionary spending by offsetting the increases with cuts in mandatory spending (PAYGO) programs. Partial, short-term government shutdowns have also occurred in other years, but they are not an intrinsic part of the US budgeting procedures. They do demonstrate the powers of the caps to force political compromise, even if the process to reach that compromise is an inefficient one. It is also interesting to note that although resolution of the shutdown situation may have provided a political victory to the President, Table 2 indicates that fiscal year 1996 was the only year in the 1993 - 1998 period where actual outlays were less than the caps.

- **Deficit Targets**. G-R-H established deficit targets enforced by sequesters. Although G-R-H may have held deficits to below what they would have been in absence of the law, the deficit targets were not reached. This failure of the deficit target mechanism can be attributed to the fact that governments can only affect legislation; they cannot directly affect the impact that the economy or demographics and other technical changes have on the budget.

The G-R-H period (1985-1990) in the US revealed that even if Government restrained spending and tax changes to not add to expected deficits, deficit targets could be exceeded because of unforeseen and unavoidable economic and demographic changes. Moreover, it was learned that enforcement mechanisms that required cuts in spending as a result of unforeseen and uncontrollable economic and demographic changes would not be tolerated by the political process. The failure of G-R-H led directly to the use of caps and PAYGO, which assisted the powerful engine of economic growth in eliminating deficits and producing surpluses by making sure the budgetary effects of economic growth were not squandered on new spending or tax cuts.

- **Employment Limits**. Limits on Federal employment are at best redundant to the caps and at worst counterproductive, sometimes encouraging inefficient contracting - out to non-Federal firms or over reliance on capital. The cost of Federal employees is included under the caps and equal only about 14 per cent of total Federal spending.

- **Special Caps**. Caps for subcategories of annually-appropriated spending (such as defense, highways, mass transit) are counterproductive. In essence, special caps create an incentive to spend up to the cap for each special category even if the spending could be more effective on other programs outside the special category.

- **Line Item Veto**. Although there was much publicity about providing the President with the authority to veto individual parts (or lines) of legislation, this tool has little value in restraining spending. The opportunity for political tradeoffs between the President and the proponents of specific spending provisions meant that there was little chance of this provision having much, if any, impact on total spending. The authority may have provided the President a new tool to promote his priorities vis a vis the Congress' priorities, but it did nothing to assist overall fiscal constraint.

V. US Budget Procedures and Allocative Efficiency, *or* Win One for the GPRA

The budgetary laws and practices have helped the US Government eliminate its deficits. An additional benefit is that they have helped and should continue to help the allocative efficiency of government spending. This has not been a quick result, nor one easy to measure, but the political trade-off between competing funding proposals has generally placed greater value on those proposals with better effectiveness and efficiency.

Evidence to support this view can be found in the enactment of the Government Performance and Results Act (GPRA) of 1993. GPRA requires that Federal agencies develop performance measures for each program and apply these measures in evaluating the results produced by the programs. Although there were many reasons supporting the enactment of GPRA, one of them was the pressure that the BEA rules (particularly the caps) placed on finding new ways to fit increasing demands for spending under tighter and tighter caps. GPRA is a legislatively mandated requirement for program evaluation that will help provide policy-makers with information to assist their decisions. It itself is not a complete answer to what programs to fund, but it can and should help the process toward a more efficient allocation of limited resources.

Another piece of evidence to support the view that the caps promote allocative efficiency is the introduction and expanded use of decision mechanisms that rely less on political judgements and more on non-political analysis. One example of such a mechanism is the Base Realignment and Closure (BRAC) mechanism. Congress passed a law establishing a BRAC commission independent of Congress that, working with the Department of Defense, uses non-political analysis to produce a list of military facilities to be reduced or closed. If the President accepts this list and transmits it, Congress may approve or disapprove it, but they cannot change the bases on the list or the specific proposals for them.

The impact of the BRAC law is to reduce the political element in base closure decisions and increase the analytic component. Like GPRA, it provides another tool to help obtain efficient allocation of limited resources. The BRAC mechanism has been applied to the reduction in size of or closure of military bases, but it may be applied to other areas.

VI. Conclusions, *or* Let No Good Deed Go Unpunished

The growth in the US economy is primarily responsible for eliminating the US Government's deficits. Continued growth promises surpluses over the near future. Budgetary laws and practices have clearly helped eliminate deficits and they are absolutely needed to keep the surpluses from being spent away.

The application of these laws and practices is not easy. The prospect of large future deficits that will result from meeting current social insurance obligations for the baby boom generation could provide some assistance to continuing fiscal constraints. But in the US, using all of the surplus to pay down the Federal Government's $3.7 trillion in debt receives little discussion, despite the assistance this would provide in increasing national savings and thus growing the economy in the future. Instead, most of the current debate is over how to break the BEA constraints to permit spending the surpluses on new programs or reducing it through tax cuts.

In addition to these major efforts to in essence abandon the BEA, individual program proponents are constantly searching for ways to evade budgetary constraints. Groups of legislators, seeking to protect favored programs, frequently attempt to carve out specific exceptions to the rules. Creative financiers produce elaborate public/private partnership schemes to expand government spending that sound attractive, but always end up costing taxpayers more than necessary.

Central budget offices will receive little help or rewards for policing budgetary rules, but the rules' effectiveness in helping to improve fiscal policies and the economy makes the effort worthwhile.