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RISING BUDGET SURPLUSES SHOULD BE TRANSFORMED INTO FALLING TAXES

Both the Congressional Budget Office (CBO) and the Administration's Office of Management and Budget (OMB) foresee huge federal budget surpluses during the next decade under current policies. CBO projects total surpluses of \$4.2 trillion over the period 2001-2010, under its intermediate assumption regarding Washington's adherence to discretionary spending caps, and OMB looks to total surpluses of \$3.1 trillion over the same years in its current-services projection. These numbers are much larger than those CBO and OMB issued only a few months ago. Compared to last July, CBO has raised its baseline projection for the period 2000-2009 by \$880 billion and OMB has increased its projection by about \$170 billion. Even if it makes the pessimistic assumption that the spending caps will fail, CBO now projects a decade-long surplus almost as large as the one it projected six months ago under the optimistic assumption that the caps will hold.

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The new figures strengthen the case for using the surpluses to finance deep and powerful tax reforms. First, it is increasingly clear that the surpluses are real and enormous. They can finance deep tax cuts without the federal budget going into deficit. Second, the reason why CBO and OMB raised their projections highlights the desirability of pro-growth tax reforms. Economic growth is driving the surpluses, and the surest way for the federal government to facilitate more growth and reduce the odds of an economic downturn is to enact legislation that reduces tax biases against work, saving, and investment. Third, the reason why CBO's upward revision was not higher and why OMB's revision, though large, was much smaller than CBO's, reveals an additional reason for reducing taxes. Money left in Washington will largely be spent on an expansion of government; that is already happening. Unless bigger government is judged more desirable than lower taxes, taxes should be cut decisively now.

The federal budget surpluses are real. For years, some people claimed they would favor tax relief if only the federal budget were not in deficit. Then, when the budget moved into surplus in 1998, some doubters called that a fluke and insisted that surpluses in succeeding years would be too small and uncertain to warrant tax relief.

But as government estimators have steadily revised their surplus projections upward, that excuse for denying tax relief has rapidly lost credibility. For instance, in January 1996, CBO's estimators projected a 1999 deficit of \$219 billion and they continued to project a 1999 deficit, though smaller with each revision, through their January 1998 estimate. In actuality, the federal budget registered a \$124 billion surplus in 1999. Similarly, in January 1998, CBO's estimators projected that surpluses would not begin until 2001 and would total less than \$400 billion over the period 1999-

Institute for Research on the Economics of Taxation

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

2006, but in fact surpluses began in 1998 and, after six upward revisions, CBO's estimators now project a baseline surplus of $2,100 billion over the years 1999-2006.

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Although the future is never cast in stone, all evidence points to very large budget surpluses. Unless one adopts the extreme position that advance planning should be completely abandoned and tax and spending commitments never made more than a year in advance, large budget surpluses should be regarded as real and as a credible financing source for tax relief. As with other advance planning, plans can be modified, if changed future circumstances warrant.

Growth drives the good budget news. The federal budget surplus has increased dramatically over the last several years because the economy has been stronger than CBO and OMB had earlier predicted. A robust economy helps the federal budget on two fronts: it lifts government revenues, in that an expanding economy gives the government more to tax, and it lowers outlays for some government programs, especially means-based ones. Since last July, chiefly because of its updated growth assumptions, CBO has increased projected revenues by $651 billion for the period 2000-2009 and reduced projected spending by $355 billion for the same period, a growth-related shift of $1 trillion.

> ***We cannot take the continued growth of the economy for granted. But rather than use that uncertainty as an excuse to forego a tax cut, it would be wise to use the surplus to ensure that the growth continues.***

Moreover, the current numbers are probably still too low. Even though real GDP's growth rate has averaged 3.8% over the last 5 years, 3.0% over the last 10 years, 3.0% over the last 20 years, and 3.1% over the last 30 years, CBO projects that it will average just 2.8% over the next decade, and OMB projects only 2.7%. If the economy's future performance is merely average, baseline budget surpluses will be much larger than the already immense ones that CBO and OMB are currently projecting.

The main benefit of growth is not that it fattens the U.S. Treasury but that it improves the well-being of the population. With that in mind, a wise use for the budget surpluses would be to remove tax barriers that now harm the economy. Tax biases punish people who save and invest and encourage them to consume. High taxes reduce the rewards for work, causing people to work less and in less efficient ways. The projected surpluses are sufficiently large that they could go a long way toward correcting these anti-growth provisions in the tax code. Part of the surpluses should be used to help finance the transition from the tax-and-transfer Social Security system to private retirement accounts that generate real saving. And part of the surpluses should go toward income tax reform. Some examples of positive steps to relieve anti-growth income tax biases would be cutting marginal individual and corporate income tax rates, abolishing the capital gains tax and the double-taxation of dividends, and allowing businesses to deduct capital expenditures when the costs are incurred rather than long afterwards (i.e., replacing depreciation allowances with expensing). The boldest initiative, with the greatest potential to foster growth, would be to replace the current income tax system with a saving/consumption-neutral tax system based on consumed income.

Higher government spending will consume most of the surplus not returned to taxpayers through tax relief. Washington has already begun spending projected budget surpluses on increased federal outlays. CBO estimates that spending legislation enacted in 1998 reduced budget surpluses by $48 billion for the period 1999-2008 and that, since last July, additional spending bills reduced budget surpluses by an another $109 billion for the period 2000-2009. And that may be just the start. In this year's budget documents, the Administration has redefined its budget baseline to quietly shift more than $1 trillion over the next decade from budget surpluses to higher outlays: the Administration ignores the caps on discretionary spending that were enacted as part of the Balanced Budget Act of 1997. Many members of Congress also seek to scrap the spending caps. The message is that if one wants to grow government, keeping the surpluses in Washington is great news, but if one wants economic growth, the surpluses should be converted into deep tax cuts without delay.

Summary. With each budget update, it becomes increasingly clear that federal taxes are much too high and could easily be reduced. Because the present federal tax system is immensely complicated and distortionary, it slows the economy, holds back productivity, lowers real wages, and reduces future opportunities. We cannot take the continued growth of the economy for granted. But rather than use that uncertainty as an excuse to forego a tax cut, it would be wise to use the surplus to ensure that the growth continues. Pro-growth tax reforms funded by budget surpluses would pay rich dividends to the American people by helping to sustain the current expansion and promoting long-run economic growth.

Michael Schuyler
Senior Economist

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.