Issue Brief

A Publication of the Institute for Policy Innovation January 28, 1999

250 South Stemmons, Suite 215 • Lewisville, Texas 75067 • (972) 874-5139

Honey, I Shrunk the Surplus

How Clinton and Congress Squandered Your Fiscal Future

By: Lawrence A. Hunter, George A. Pieler, and James Carter

1998 was supposed to be the year when fiscal good times finally overflowed the U.S. Treasury and put money back into the pockets of ordinary Americans in the form of tax cuts. When surging revenues promised to balance the budget four years ahead of the "schedule" envisioned by the 1997 budget deal, the path to lower taxes finally seemed clear.

The 1998 budget was balanced, all right, and ended up $70 billion in surplus by official estimates. But not only were there no tax cuts, the emerging balance-of-fiscal-power threatened to forestall *any* significant tax cuts for the foreseeable future. And the share of America's economic pie taken by government in taxes hit a peacetime high of 20.5% and is projected to remain above 20% in coming years.

Worse yet, our leaders in Washington managed to fritter away more than $20 billion of the projected budget surplus for FY 99 *alone* on a bewildering array of old-style pork-barrel and "emergency" spending. What happened?

"Our leaders in Washington managed to fritter away more than $20 billion of the projected budget surplus for FY 99 alone on a bewildering array of old-style pork-barrel and 'emergency' spending."

The answer lies in sharp but dishonest strategizing by the Clinton administration, and the unwillingness of Congress to seize the policy (and political) high ground of coupling meaningful tax cuts with true Social Security reform. To find a way out of this conundrum, we need to start at the beginning: with the emergence of the budget surplus and President Clinton's call to "save Social Security first," driving a wedge between the growth and austerity wings of the conservative movement.

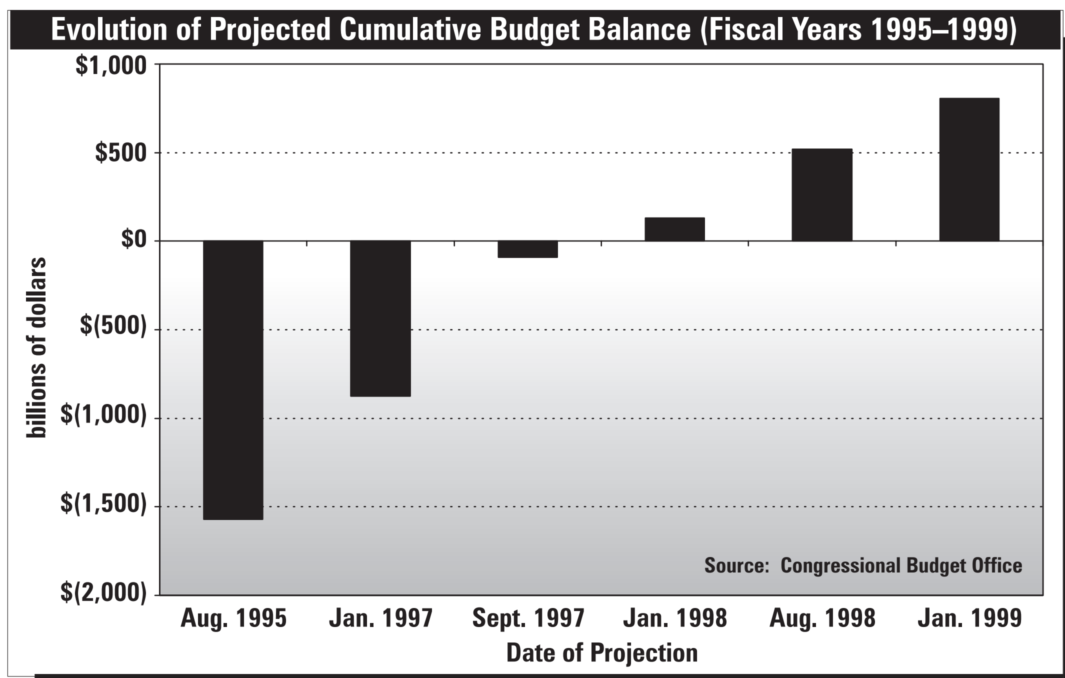
The Surplus

Prior to last year's surplus, the federal government had balanced its books only twice since the final years of the Eisenhower administration—with the most recent surplus appearing in 1969. Not surprisingly, most Americans believed they would never see the federal government register a budget surplus in their lifetimes. Until just a few years ago, it seemed as if the American people would be proven right.

In just three and a half years, however, the Congressional Budget Office's ("CBO") budget projection for fiscal years 1999 through 2003 has shifted from a cumulative deficit of $1.6 trillion to a cumulative surplus of $800 billion (see Figure 1). The projected deficits vanished so swiftly and suddenly that many taxpayers still doubt the validity of the official statistics.

Figure 1
Evolution of Projected Cumulative Budget Balance (Fiscal years 1995–1999)

Source: Congressional Budget Office



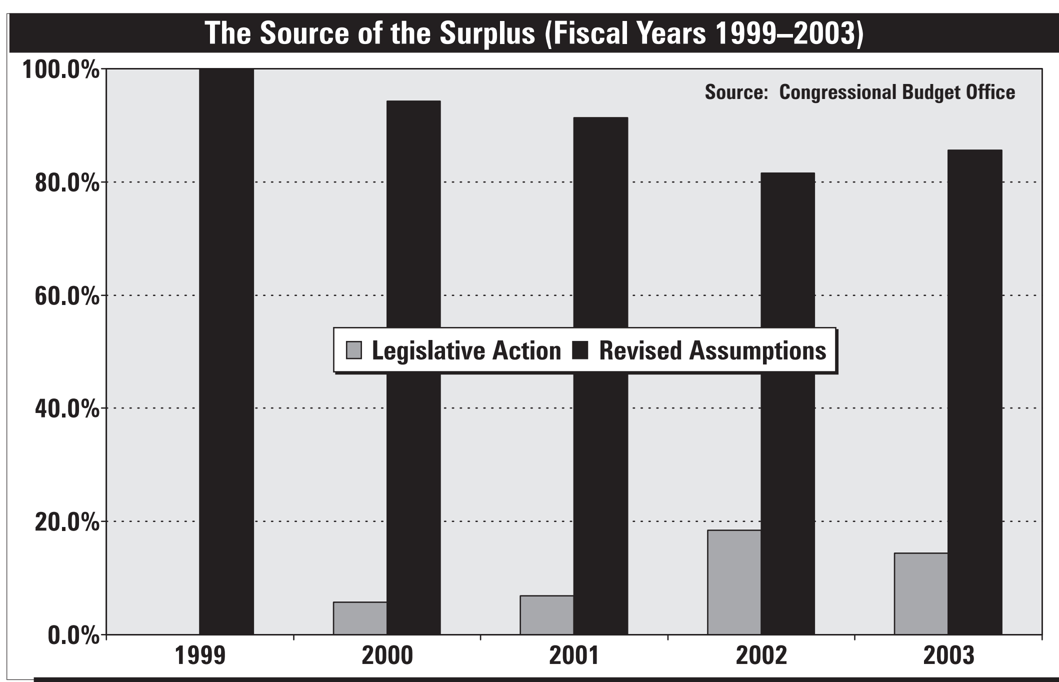
"CBO attributes only 10 percent of the shift in that five-year budget projection to legislative changes passed by Congress and signed by the President."

Actually, the American people should doubt those in Congress and the White House who claim to have produced the surplus by taking a sharp knife to the budget. CBO attributes only 10 percent of the shift in that five-year budget projection to legislative changes passed by Congress and signed by the President. The vast majority—90 percent—of the change stems from revised economic and technical assumptions (see Figure 2).

While the politicians deserve only modest credit for producing the budget surplus, they are eager to dictate its use. President Clinton was first out of the block last year when he called upon Congress to "save Social Security first," perhaps the grandest fiscal deception since the 1990 budget deal.

Figure 2
The Source of the Surplus (Fiscal years 1999–2003)

Source: Congressional Budget Office



Taking the Pledge

In his 1998 State of the Union address, Bill Clinton heralded the imminent balancing of the Federal budget (actually, as close observers and savvy forecasters knew, the budget was already in balance as he spoke) and the prospect of significant budget surpluses in the years ahead. The President then urged devoting *all* of such surpluses to "saving" Social Security, i.e. "preserve" the surpluses until politicians act to correct fundamental structural imbalances in the Social Security programs.[1]

The "Clinton Pledge" was a political gesture pure and simple: by linking budget surpluses and "saving Social Security" in the public's mind, the President tried to forestall, above all, serious efforts to rebate surpluses to the taxpayers who had generated them in the first place.

"By linking budget surpluses and 'saving Social Security' in the public's mind, the President tried to forestall, above all, serious efforts to rebate surpluses to the taxpayers…."

And the gambit worked. Although Republican tax cut initiatives surfaced repeatedly throughout the year, they all ultimately collapsed in the face of charges that they were "robbing" the Social Security trust funds ("squandering" surplus revenues by giving them back to the taxpayers who generated them). Tax-cutters were put in another bind by official CBO interpretations of the budget rules, alleging that tax cuts had to be "paid for" with offsetting tax hikes or entitlement cuts even in an era of surpluses.[2]

Coupled with a year of White House-led "consciousness raising" about Social Security, Clinton's pledge to "save" surpluses for that program effectively shut down the tax-cut movement for 1998. But at least the surpluses weren't squandered on Federal spending, right? After all, if you're "saving" surpluses for Social Security, you can't spend them any more than you can return them to taxpayers.

Wrong! In fact, by the end of FY 1998 the President and Congress had managed to throw away at least $20 billion (probably a lot more) of the projected 1999 surplus on miscellaneous spending programs, any and all of which could easily have been accommodated within the regular budget framework without tapping a cent of the surplus. Let's look at some of the gory details of how this happened.

The Urge to Splurge

While the notorious surplus-busting Omnibus/Emergency appropriations bill that capped the 105th Congress is the largest example of how the surplus was plundered, the "spend the surplus" syndrome emerged early in 1998 (actually, it emerged in 1997, when gross underestimates of revenue flows were suddenly adjusted to accommodate new spending under the '97 budget deal—but that's another story). The early symptoms were the Administration's demand for an $18 billion cash infusion for the International Monetary Fund (IMF), and Congress' eagerness to dole out scores of new highway, mass transit, and "infrastructure" projects under the new Highway Bill.

"By the end of FY 1998 the President and Congress had managed to throw away at least $20 billion (probably a lot more) of the projected 1999 surplus on miscellaneous spending programs…"

The IMF funding proposal, which languished during most of 1998 due to congressional concerns about IMF accountability and policies, is usually omitted from calculations of how much of the FY 1999 surplus has been "spent". Indeed, U.S. Treasury Secretary Robert Rubin claims that the IMF has not cost the taxpayer one dime.[3]

Contrary to the assertions of Messrs. Rubin and Camdessus (of the IMF), the IMF contribution not only constitutes real outlays of federal tax revenues (even though they are kept out of the federal budget by a special accounting device), it also produces a higher national debt than otherwise would be the case in the absence of the contribution. Here's why.

First, an IMF quota increase is usually paid one-quarter directly in the form of hard currency, i.e., tax dollars, and three-quarters in the form of a letter of credit to be redeemed for hard currency (again, tax dollars) when needed. If the usual practice is followed with the (roughly) $14 billion quota increase authorized in the 1998 budget deal, about $3.5 billion will be transferred to the IMF during the next twelve months.

Second, the IMF lends money to its clients at subsidized interest rates, which are below the rate the Treasury must pay on U.S. Treasury bonds. The Congressional Research Service calculates that this interest-rate differential has added at least $4.6 billion to the national debt.[4] Therefore, the recent $18 billion IMF replenishment is highly relevant to any calculation of how the surplus has been frittered away. Over and above the eventual release of the full $18 billion, adding new debt as a result of the interest-rate differential obviously crowds out the goal of using the surplus to *reduce* outstanding debt.

"The IMF contribution not only constitutes real outlays of federal tax revenues….it also produces a higher national debt than otherwise would be the case."

The highway bill, enacted earlier in the year, is a different story, since technically all the spending increases it contains were accommodated within the limits prescribed by the 1997 budget deal. There is more here than meets the eye, however, since the additional spending committed to highway projects puts severe pressure on the so-called "spending caps" that are supposed to restrain discretionary spending in future years (critically important to keep the surpluses coming).

That brings us to the big year-end spending blowout, which packaged together some funds that truly represent emergency disaster relief (for hurricane and flood damage, for example) with items labeled "emergency" that clearly were foreseeable and should have been handled within the agreed-on spending caps (that is, the limits on discretionary spending agreed on in the 1997 budget deal and enforceable under the budget act). These include things like additional cash for peacekeeping efforts in Bosnia, strengthening embassy security, and accelerating efforts to get government computers ready for the Y2K transition. It also included a package of measures designed to enhance national security, including $1 billion for work on strategic defense and money for military pay and beefed-up intelligence (much of this funding is not specifically earmarked, with actual priorities to be set by DOD).

Arguably much of this spending represents a positive shift in priorities, but characterizing it as "emergency" allowed Congress to spend this money without having to set priorities relative to other, less important programs and stay within the budget caps. Surpluses make it easier to simply add new spending with no trade-offs. Moreover, a strong case can be made that true emergency spending should be handled through a reserve set-aside in the budget process (as we know, government can't "save" or "reserve" cash, but it *can* set aside spending authority within an overall budget plan). Since that isn't done, and since the budget rules expressly exempt emergency spending (as well as IMF funding, by the way) from rules constraining discretionary spending, the process puts a huge premium on labeling an item "emergency" in nature. In 1998 Congress and the White House took a flying leap through precisely that loophole.

Assessing the Damage

Quantifying the projected surplus revenues that were spent (squandered?) during the 1998 congressional session is almost an art, because official reestimates of the budget have only just been released. Nevertheless, even with the limited data at hand, it is possible to make an educated guess about how much of the surplus was swallowed up by the federal spending machine.

Let's start with the *official* numbers, which represent the "low water mark" estimate of how much of the budget surplus has been dissipated. According to the November 5, 1998 Monthly Budget Review of the Congressional Budget Office, "legislation enacted since CBO's July projections add an estimated $17 billion to 1999 outlays, reducing the projected total surplus to $63 billion ..." This is principally a reference to the spending increases contained in the omnibus appropriations bill. However, this figure significantly understates the magnitude of those post-July spending increases for a number of reasons.

First, CBO's $17 billion figure covers only spending that shows up in the FY 1999 budget totals. According to sources at the congressional budget committees, Congress pushed some additional spending back into FY 1998 (which ended September 30), and advanced some additional spending into FY 2000 (which begins October 1, 1999—so-called "forward funding"). Exact figures for this non-FY 1999 spending will not be available until the formal presentation of the FY 2000 budget, but estimates in the $9 billion range have been cited by a number of reliable sources.

"At a minimum, the government has disposed of roughly one-quarter (the $20 billion) of the previously projected surplus for FY 1999."

A number of organizations have cited the figure of $20-21 billion as the amount of the projected FY 1999 surplus that was soaked up by the omnibus appropriations bill. The difference between this figure and CBO's $17 billion may be accounted for by the fact that CBO appears to have offset the new spending in the omnibus bill with a downward revision of the overall spending estimate it made in July, 1998. For purposes of discussion we will use the round figure of $20 billion for the FY 1999 *legislated* spending that raided the surplus.

What do we have, then, as the total picture? At a minimum, the government has disposed of roughly one-quarter (the $20 billion) of the previously projected surplus for FY 1999. Given the political dynamics of the spending process, it is quite reasonable to assume that whatever figure we accept for new spending forward-funded into FY 2000 (let's use the $9 billion figure as the best guess) will in fact be trumped and increased even more (perhaps a lot more) as Congress goes through the FY 2000 budget cycle. In addition, the spending commitments implicit in the highway bill will (in combination with the omnibus blow-out and other factors) put extreme pressure on the budget "caps" that CBO relies on in making its out-year spending projections. Since there is no obvious way to quantify this effect, however, let's cite the highway bill as an important risk factor for further raids on the surplus piggy bank.

Finally, there is the IMF bailout, which doesn't show up as new on-budget spending, but which is likely to increase Federal borrowing to the tune of (roughly) $5 billion in the near future. Add those figures together as a crude measure of how much of the projected budget surplus has been spent, and you get a grand total of $34 billion: funds that could have been used for tax reduction, debt retirement, or "saving Social Security" (however that amorphous goal is defined).

That's bad enough. But it is not the end of the story.

Looking Ahead

It would be one thing if the government's 1998 spending spree were a one-shot deal, and (aside from shifting funds across fiscal years) it had no other implications for soaking up surpluses projected for the next few years (in July CBO projected those cumulative surpluses as $1.6 billion over ten years). As a matter of simple logic, however, that simply is not possible.

As Martha Phillips (Executive Director of the budget watchdog group The Concord Coalition) said on October 20, "this omnibus bill signals a major breakdown in fiscal discipline..." Phillips went on to say, with regard to key spending items in that bill, that "These needs, if deemed priorities, should be funded through the normal budget process."

Phillips' point, in brief, is that the *contents* of the omnibus bill lead inexorably to the conclusion that the same amounts, if not more, will be spent in the next few fiscal years. Rather than offset these items against other policy priorities in the regular budget process, Congress and the President lumped them into the omnibus year-end binge, sending the bill to the taxpayers who, after all, generated the budget surplus in the first place.

Carol Wait of The Committee for a Responsible Federal Budget, another fiscal watchdog, makes a similar point when she observes that simple common sense tells you that items like increases in military pay (included in the omnibus bill) are going to be recurring costs, particularly at a time when many observers rightly feel that national security and strategic defense have been seriously underfunded (in fact, defense-related accounts have borne most of the brunt of discretionary spending cuts throughout the 1990's). The fact that Congress and the White House are now waking up to the national security problem doesn't change the fact that they are supposed to establish these kinds of priorities in the context of the overall budget, not fund them as afterthoughts by raiding the much-hyped budget surplus.

"The recurring spending implicit in the omnibus bill could add up to $100 billion (or more) over five years—ironically, a much higher figure than the $80 billion tax cut (over five years) that House Republicans struggled in vain to move late in the 1998 session."

Wait, in fact, estimates that the recurring spending implicit in the omnibus bill could add up to $100 billion (or more) over five years—ironically, a much higher figure than the $80 billion tax cut (over five years) that House Republicans struggled in vain to move late in the 1998 session. This means that the so-called budget "caps" which CBO relies on in projecting the surplus cannot possibly hold, and further spending sprees are likely to ensue.

The situation may be even worse than that, however. Some of the programs included in the omnibus bill (such as the provision for funding 30,000 new public school teachers) have built-in expansion written all over them. Congress has put up the funds for 30,000 teachers, but they and the President have promised funding for 100,000. What force is going to stop them from delivering on that promise?

In addition, actual spending could be significantly higher due to risk factors built into the budget process itself. A lot more "new" spending was authorized in 1998 than the (net) figures we have discussed above would suggest. That's because it was squeezed into the budget by using "offsets" (policy changes that purport to save an equivalent amount of money for the government) rather than raising the surplus directly.

There are lots of examples of this (probably more than even the budget experts have identified so far), but let's start with the "new teachers' program for now. According to a recent "Viewpoint" column by Joel Mowbray in *Investor's Business Daily*, the teacher program is "offset" by allocating assets from the District of Columbia teacher's pension fund (for which Congress assumed financial responsibility for in 1997). On the books, this leaves the District fund solely reliant on annual contributions, and implies future liability on the part of the Federal government for any resulting shortfalls. Is this really the way to "save" money?

Without trying to quantify the problem (virtually impossible to do), the bottom line is that in 1998 the President and Congress conspired to spend at least one-quarter of the FY 1999 budget surplus (probably more like a third or more); virtually obligated the government to spend the same amount (or more) of future surpluses; and built in a fiscal time-bomb that will burst the budget "caps" and almost surely lead to further raids on the surplus.

An ironic outcome for a year in which President Clinton demanded that those very same surpluses be "saved" for Social Security. Even more ironic is the fact that no Republican politicians (except in the most timid fashion) hammered home the point that Clinton's Social Security pledge, aside from freezing the budget debate, was completely disingenuous, since he had no objection to "raiding the trust funds" for new *spending*; just not for tax cuts.

The Failure of Moral Equivalence

One lesson that can be learned from the experience of 1998 is that establishing moral equivalence (in the context of the budget process) between taxes and spending is a recipe for disaster—from the standpoint of the taxpayer, that is.

By "moral equivalence" we mean the notion that the only difference between a spending increase and a tax cut is the difference between a plus and minus sign. Not only does this ignore the obvious economic differences between the two, it leads to some perverse thinking. For example, it led CBO Director June O'Neill to advise the Senate (in October, 1997) that a surplus is just a "negative deficit." It also concedes that there is such a thing as a "tax expenditure," no different from a spending program; and that *legislated* changes in taxes and spending should be treated similarly in the budget process.

Moral equivalence betrays the interests of the taxpayer for the fundamental reason that taxes rise automatically in periods of robust growth—that in fact is what is generating our budget surpluses. Much federal spending also rises automatically due to the design of programs (such as entitlements), yet the budget process interposes obstacles to reducing the automatic revenue growth (it would "add to the deficit" or "reduce the surplus") but none whatever to the automatic growth of spending. The result is a clear bias in favor of higher spending and ever-higher revenues as a share of GDP—i.e., an automatic ratchet for the growth of government. What's more, the budget process provides any number of tricks and strategems for increasing spending (phony offsets, declarations of "emergency" status, time-shifting) but little of the same magnitude on the tax side (although time-shifting, to use one example, can apply there too).

"The result is a clear bias in favor of higher spending and ever-higher revenues as a share of GDP— i.e., an automatic ratchet for the growth of government."

Aside from these procedural biases, the experience of 1998 shows that moral equivalence is a *rhetorical* disaster for tax-cut proponents. Here we have a situation where taxes are at a record peacetime high as a percent of national income, budget surpluses are projected as far as the eye can see, and yet the political will to cut taxes collapsed in the face of a barrage of "save Social Security first" rhetoric. That same rhetoric, however, did nothing to prevent Congress from spending a huge chunk of the same projected surpluses.

The fact is that until taxes and spending function in the same way for federal budget purposes (e.g., a flat tax coupled with a spending freeze), assuming equivalance (moral or otherwise) between the two will always be to the detriment of the taxpayer, and more 1998-style spending sprees will be standing operating procedure.

A Few Thoughts on Remedies

Since advocates of spending restraint and tax relief clearly have a problem here, what can be done about it? Several different approaches seem to be emerging.

Making the trains run on time. This is not just a facetious suggestion, but former House Speaker-to-be Bob Livingston's characterization of his own recommendation for avoiding another 1998 spending bonanza—sticking firmly to the budget procedures and guidelines, particularly the official timetables, and working with committee chairmen to finalize spending and tax decisions as early as possible in the budget year.

Keeping the trains running on time must also mean keeping them on the right track, one hopes. This, if strictly adhered to, probably would produce a better result than we saw in 1998. The weakness, however, is that it depends on the particular personalities of the players in the budget process, their willingness to respond to the Speaker's leadership, and on the Speaker's own willingness to resist political pressure to spend and enforce his will on the House. That's a tall order, and what about the Senate, which is much less rule-bound than the House?

Lockboxes. A number of proposals have been made in recent years to reserve budget surpluses and "protect" them from the regular budget process by using a procedural "lockbox'—a separate item in the budget, funded by projected surpluses, that could be tapped to reduce revenues or draw down debt, but not for new spending. The idea is that by taking surpluses out of the usual budget deliberations, we could improve the odds that Congress will stick to spending priorities established within an overall spending total.

The lockbox notion certainly is conceptually sound, but it has shown no signs of gaining any political traction. In addition, when Congress is as bound and determined to spend money as it was this past year, there is little likelihood that a lockbox mechanism by itself could stop the politicians from breaking into the surplus reserve and divvying up the goodies.

Give it back. While this is the crudest answer to the problem of surplus spending sprees, ultimately it may be the most effective. A commitment to give surplus revenues back to the taxpayers who generated them has the advantage of creating a decisive political constituency for both tax and spending restraint, and shifts the burden of proof back to those who want to spend more. It's not a managerial solution (à la Livingston) or an abstract procedural device (the lockbox), but rather a raw political counterweight to government's tendency always to spend more. What it requires, though (as indeed does any viable remedy) is strong political skills and a willingness to stand tough in favor of a pro-taxpayer agenda. Because, after all, the problem of spending the surplus is a problem of political will, not of rules, procedures, or management practices.

Dr. Lawrence A. Hunter is Chief Economist at Empower America. George A. Pieler is a writer based in Washington, D.C. who has worked extensively on tax and budget issues. James Carter is a Senior Economic and Budget Advisor in the U.S. Senate.

Copyright ©1999
Institute for Policy Innovation

Nothing from this document may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without permission in writing from the publisher, *unless such reproduction is properly attributed clearly and legibly on every page, screen or file.*

The views expressed in this publication do not necessarily reflect the views of the Institute for Policy Innovation, or of its directors, nor is anything written here an attempt to aid or hinder the passage of any legislation before Congress.

Direct all inquiries to:

Institute for Policy Innovation
250 South Stemmons,
Suite 215
Lewisville, TX 75067

(972) 874-5139 [voice]
(972) 874-5144 [fax]

Email: **ipi@ipi.org**
Website: **www.ipi.org**

Endnotes

1 See Lawrence A. Hunter, "Will Taxpayers Be Last in Line for Budget Surpluses?", *IPI Insights*, Institute for Policy Innovation, Spring 1998.

2 For a more detailed discussion of this problem, see *Budget Rules for Good Times: Ending the Budget Game As We Know It*, by George Pieler, IPI Policy Report #146, Institute for Policy Innovation, August 1998.

3 Vasquez, Ian, "The True Costs of the IMF," Cato Institute, April 1, 1998.

4 Vasquez, *op cit.*