

Spending Future Surpluses: A Return to Normalcy?

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Although it is probably too late this year for Congress to undertake any significant tax cut, the temptation to spend future surpluses will not go away in the near future. The issue likely will arise in different ways in both the congressional campaign later this year and the presidential election in 2000. Even the promise to save the surplus for social security reform may only temporarily deter Congress, partly because the enactment of social security reform itself could involve some spending down of those surpluses.

Many believe that the spending of projected surpluses is an unknown world. In point of fact, what we are witnessing is an attempt to return to normalcy. Throughout much of this nation's history, Congresses have been able to enact new expenditures or tax cuts, yet without legislating new means to pay for the expansions. These actions were made possible by the continual generation of future budget surpluses -- revenues in excess of expenditures. It has only been in the years since the late 1970s that deficits began to stretch out "as far as the eye can see."

How can this be? The United States has seen substantial growth in income in every decade of its history, including the Depression-led 1930s. This growth in income almost always has led to an increase in revenues to government that was significantly in excess of the rate of inflation. True, the increase was unusually large as inflation accelerated in the 1960s and 1970s when the income tax was not indexed for inflation. But those special circumstances should not make us forget that a growing economy practically always increases revenues even if it does not increase the average rate of tax applied to that income.

Today the tax system provides revenues that grow at approximately the same rate as economic growth. While excise taxes grow more slowly than the economy, the income tax has a modest amount of built-in rate increases (bracket creep) that accompany rises in real incomes, whether due to higher wages, more dividends, or simply more workers per family. These slower-than-average and faster-than-average growth rates, when combined with roughly proportional social security taxes, roughly balance out to produce a system where revenues are projected to be roughly proportional to income.

Accordingly, the Congressional Budget Office predicts that real (inflation-adjusted) revenues in 10 years will be approximately 20 percent higher than they are today because it anticipates that the economy itself will be 24 percent larger. Imagine a government in which all programs were permanent, but had no built-in growth rate. Then also imagine starting out today with a deficit of zero. Over the course of about 10 years, then, revenues would eventually rise to 20 percent (hundreds of billions of dollars annually) in excess of expenditure commitments.

That we see no projections of this magnitude is due to the simple fact that many programs of government have a built-in growth rate that eats up future revenues. True, there is a moderate surplus projected for the next 10 years or so, but the situation quickly turns around as the baby boomers start to swell the ranks of the elderly, and the built-in growth in promises in social security and Medicare start to hit the system with a vengeance.

That this reprieve is temporary, however, should not mask its resemblance to the normal historical practice. Looming deficits in the near and far term are the exception, the dilemma of modern government. Only with the dominating impact of growing entitlements, a phenomenon unknown in our past history, have we come to expect automatic expenditure growth to exceed the growth in revenues that accompany an expanding economy. Whatever the cause of the deficits before the modern period -- Depression, war, new benefits accompanying a peacetime expansion, or a recession -- future revenues almost always eventually caught up and began to dominate future obligations written into current law.

Why is this historical understanding so important? Spending of surpluses may not make sense when they are

merely temporary; that is, when generated at the peak of an economic cycle or when future, unfunded obligations are looming around the corner. Barring this important exception, such actions are a normal, not abnormal, course of events, and the eventual reining in of entitlement growth could restore this common congressional practice.

Think of the family budget. Typically, few families obligate themselves as to what they are going to spend 10, 20, or 50 years into the future. They would consider such an exercise dangerous and silly. They don't know what are the most important goods and services that will be available at that time, nor what new needs will arise. Even if they hope that their income will be larger, they will not necessarily make obligations too far into the future. What families do, politicians legitimately want to do: spend future "surpluses" as they become available over time. Unfortunately, politicians also want to take credit for additional expenditure increases and tax cuts today are charged to future generations.

A delicate balancing act is required. If future revenues are to be spent according to the needs of the time, then simply restraining growth in past entitlements is not enough. New tax breaks or expenditure entitlements with significant and permanent built-in growth must also be avoided. In sum, normalcy means future surpluses that can be used to increase expenditures or returned as tax cuts as each generation of voters and their representatives deem fit. Abnormalcy is created when growing tax and expenditure entitlements absorb almost all the additional taxes that future generations will pay.

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