

# The Political Economy of the Budget Surplus in the United States

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**I**n 1998, the federal government of the United States reached a budget surplus for the first time in 30 years. Even though many commentators have described this event as a rare and major success, what is remarkable is not that the U.S. government has reached a surplus, but that this result is perceived as so “exceptional.” In fact, given the strong expansion of the U.S. economy in the last eight years, and the “peace dividend” due to the end of the cold war, nobody should be overly surprised at the much improved fiscal balance. The reason why a surplus for the federal government appears so unusual is that American citizens, like those of many other industrial countries, have become accustomed to large and persistent deficits from the mid-1970s onward. In fact, many European countries, which have had much lower growth than the United States and higher interest rates, are still struggling with this legacy of accumulated debts.<sup>1</sup>

While current budget surpluses should be viewed as relatively normal, the large budget deficits of the 1980s were exceptional. According to the “tax-smoothing” theory, the budget balance should be used as a buffer to allow tax rates to be approximately constant at the level that keeps the budget in intertemporal balance.<sup>2</sup> Thus, temporary deficits are expected to occur during recessions and

<sup>1</sup> The “peace dividend” was proportionally much lower for European countries, since their defense spending was already much lower than in the United States during the cold war period.

<sup>2</sup> The theory is based on convex distortionary costs of taxation. An example of such a tax is a proportional income tax in a labor supply model where individuals choose between leisure and consumption. In a fully specified model, general equilibrium effects may lead to nonconstant tax rates, although they would still be less variable than fluctuations in spending (Barro, 1979; Lucas and Stokey, 1993).

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periods of exceptionally high spending. Conversely, budget surpluses should be the norm during expansions, like the current one in the United States, and periods of temporarily low spending, like when a (cold or hot) war ends. These are also the empirical predictions of a traditional Keynesian model of fiscal policy. Therefore, the view that the current surpluses are exceptional and offer an opportunity for doing something extraordinary has to be vastly toned down.<sup>3</sup> The tax-smoothing theory, however, does not take into account the political economy of deficits and surpluses.<sup>4</sup> How to divide the common pool of fiscal revenues and how to allocate the tax burden are the critical political battlefields in every country. The academic literatures on the macroeconomic effects of fiscal policy often ignore redistributive issues. The only type of redistribution captured by standard (nonpolitical economy) macroeconomic models of fiscal policy capture is that which occurs across generations.<sup>5</sup>

If the conflict over how to allocate fiscal resources is taken into account, then the current debate over the surplus becomes hardly surprising. In many respects, this debate is similar to the one on the question of “Who should pay for the deficits?” In a period of deficits, the conflict is about which taxes should be raised and which spending programs cut; in a period of surpluses, it is the reverse. However, there is an interesting difference between the political economy of surpluses and deficits. In a situation of fiscal surplus, resources are available to compensate the temporary “losers” of reforms that benefit a majority. In many situations, the short-run costs of certain reforms which fall on a vocal minority of the population may be sufficient to defeat the reform politically. A temporary abundance of fiscal revenues may help circumvent these political blocks. In a period of deficits, instead, compensating the losers may be more difficult if additional increases in deficits are economically (or politically) costly.

In many OECD countries, including the United States, pension reforms are the critical fiscal issue of the next decade, with important implications for long-term fiscal balance. In the last three decades, the component of government spending that has fueled the growth of government in OECD countries has been transfers, as opposed to public consumption of goods and services. Among the transfer components, pensions are in many countries the type of spending that is most “out of balance” in an intertemporal sense, because of the aging population and generous benefits. Therefore, pension reforms have to be critical ingredients of long-term fiscal stabilization in many OECD countries. However, the fraction of the current generation that would see its social security benefits reduced, or its

<sup>3</sup> Talvi and Vegh (2000) support the tax-smoothing hypothesis empirically for G-7 countries. Evidence drawn on developing countries shows, instead, procyclicality of fiscal policy. On the same point, see also Gavin and Perotti (1997).

<sup>4</sup> For a review of the literature on the political economy of fiscal policy, which departs from the tax-smoothing model and enriches it with redistributive conflicts and political competition, see Alesina and Perotti (1995a).

<sup>5</sup> The pathbreaking papers on intergenerational redistribution and public debt are Diamond (1965) and Barro (1974).

contribution increased, often has enough political influence to block social security reforms, particularly those in which the main beneficiaries are future generations. Countries in fiscal stress are caught between a rock and a hard place. On the one hand, they need pension reforms to achieve long-run fiscal stability. On the other hand, they can hardly afford compensation schemes for the losers and can hardly finance transitional measures. A country in temporary surplus with a long-run problem of solvency of its Social Security system is in a more favorable position to overcome potential vetoes to pension reforms.

One can rephrase the same concept in a tax-smoothing framework: the current U.S. surpluses are accompanied by a realization that in the not-too-distant future, the Social Security system will either require more funding or a structural reform. Thus, without welfare and Social Security reform, future spending is expected to be higher than today. According to tax smoothing, taxes should be increased today, unless reforms are introduced to reduce future spending. The argument of this paper is, then, that the tax-smoothing theory suggests the current surplus should be used to retire debt and reduce the debt over GDP ratio. In addition, if one links the current surplus to the long-run solvency problems of the Social Security system, then the surplus allows for some richer policy alternatives to only retiring debt. However, the political battle over the surplus may lead to a flurry of uncoordinated tax cuts and spending increases, which might eliminate both the options of retiring debt or linking the surpluses to Social Security reform.

The next section of this paper reviews the current and past fiscal history of the United States, which led to the surpluses, and discusses projections for the future. I then discuss the various possible alternatives concerning the question of “what to do with the surplus.”

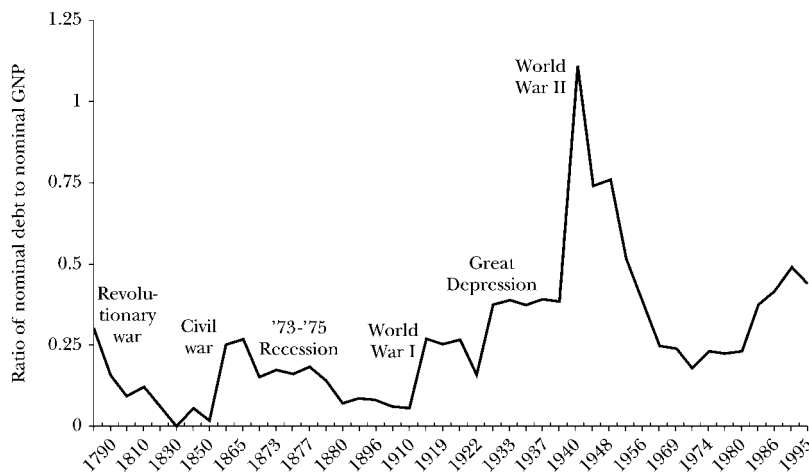
## The Budget in the United States: Yesterday, Today and Tomorrow

Figure 1 shows the debt/GNP ratio in the United States in the last 200 years.<sup>6</sup> The “tax-smoothing” hypothesis describes much of U.S. fiscal history very well. The debt/GNP ratio sharply increases during wars and declines after them. Also, as the Great Depression shows, the debt/GNP ratio increases when growth is low or negative: as a result of the Depression, the debt/GNP ratio in the interwar period did not decline as quickly as after World War II.

Figure 1 also highlights the precipitous downward trend of debt/GNP in the postwar period, from 122 percent of GNP in 1946 to 32 percent in 1979. This pattern is briefly interrupted only by recessions, especially the one after the first oil shock, and by the “local” military conflicts of Korea and Vietnam. The trend toward a declining debt/GNP ratio, which was consistent with the tax-smoothing hypothesis, is clearly reversed in the late 1970s and early 1980s. While the mediocre growth

<sup>6</sup> This is the only case in which, because of data availability, ratios of fiscal variables are expressed over GNP. Everywhere else in the paper they are expressed in terms of GDP.

Figure 1

**U.S. Public Debt Since 1790**

Source: Barro (1993)

performance in the period 1979-1982 contributes to the increase in deficits, the rest of the 1980s clearly show a radical departure from tax smoothing, as budget deficits accumulated in a period of peace and sustained growth. The debt/GDP ratio increased to 68 percent in 1995 (half held by the public): these are the levels of the debt/GDP ratio of the mid-1950s, only a few years after the end of World War II. One may argue that the 1980s were, in a sense, a period of “war”—namely, the final push to end the cold war. While this interpretation cannot be completely dismissed, it is, in my judgement, not enough to rationalize the budget outcomes of the 1980s. In summary, the fiscal policy of the 1980s was unsound from the point of view of tax smoothing.

The current budget surpluses have been the result of: 1) the exceptional performance of the American economy since 1991, a performance which has generated a surge of tax revenues; 2) low interest rates; and 3) a large reduction in defense spending as a share of GDP. In terms of discretionary policy, the Omnibus Budget Reconciliation Act of 1993 is the most important deficit reduction act of the decade, and it included a variety of tax increases and spending cuts.<sup>7</sup> As argued below, however, this act would have not eliminated the deficit without the exceptional performance of the economy and the “peace dividend.”

Table 1 shows the pattern of various components of spending as a share of GDP. After the cuts in the early 1980s, GDP domestic discretionary spending has remained constant (as a share of GDP) from the late 1980s onward, while defense spending has fallen from 5.9 percent of GDP in 1988 to 3.2 percent in 1998, the

<sup>7</sup> See Auerbach (1994) for a much more detailed discussion of this policy package.

Table 1  
Outlays as a share of GDP

Year	Discretionary Spending				Entitlements and Other Mandatory Spending					
	Defense	Domestic	International	Total	Medicaid	Medicare	Social Security	Other Retirement And Disability	Total <sup>a</sup>	Total Outlays
1988	5.9	3.2	0.3	9.4	0.6	1.7	4.4	1.1	10.2	21.5
1989	5.7	3.1	0.3	9.1	0.6	1.8	4.3	1.1	10.3	21.4
1990	5.3	3.2	0.3	8.8	0.7	1.9	4.3	1.1	11	22.1
1991	5.5	3.3	0.3	9.1	0.9	1.9	4.6	1.1	12	22.6
1992	4.9	3.5	0.3	8.7	1.1	2.1	4.6	1.1	11.7	22.5
1993	4.5	3.5	0.3	8.3	1.2	2.2	4.7	1.1	11.4	21.8
1994	4.1	3.5	0.3	7.9	1.2	2.3	4.6	1.1	11.4	21.3
1995	3.8	3.5	0.3	7.6	1.2	2.5	4.6	1.0	11.4	21.1
1996	3.5	3.3	0.2	7.1	1.2	2.5	4.6	1.0	11.4	20.7
1997	3.4	3.2	0.2	6.9	1.2	2.6	4.5	1.0	11.2	20.1
1998	3.2	3.2	0.2	6.6	1.3	2.5	4.5	1.0	11.2	19.6

Source: Congressional Budget Office (1999).

<sup>a</sup> Not reported are farm price support, deposit insurance, unemployment compensation and "others."

lowest level of the last 50 years. Given many localized conflicts requiring NATO intervention, today's defense spending may have reached a level that is, unfortunately, hard to reduce much further.<sup>8</sup> Discretionary domestic spending has instead remained constant as a share of GDP at around 3.2 percent despite various "budget deals" and "spending caps" imposed in the 1990s.

In the mandatory spending part of the budget, Medicare and Medicaid have almost doubled their share of GDP in ten years: these two programs combined were 2.3 percent of GDP in 1988 and are 3.8 in 1998. Reducing the growth of mandatory spending and entitlements is very difficult politically because these programs affect a large fraction of the population and any significant reduction of spending requires a change of entitlement rules. Even in the days of the so-called "Reagan revolution" and the welfare cuts often discussed at that time, only those programs with relatively specific beneficiaries were reduced, while broad-based programs were largely unaffected (see contributions in Alesina and Carliner, 1991).

On the revenue side, as shown in Table 2, an increase in the share of revenues as a share of GDP begins in 1994, partly as a result of the Omnibus Budget Reconciliation Act of 1993. As pointed out by Munnell (1998), the large surge in fiscal revenues has gone beyond what could be expected even with the strong economy of the 1990s. An interesting question is how much of the reduction in the debt/GDP ratio is due to the behavior of the economy (growth rates and interest

<sup>8</sup> In fact, the presidential candidate of the Republican Party, George W. Bush, is advocating a substantial increase in military spending.

Table 2

**Revenues as a Share of GDP**

<i>Year</i>	<i>Individual Income Taxes</i>	<i>Corporate Income Taxes</i>	<i>Social Insurance Taxes</i>	<i>Excise Taxes</i>	<i>Total Revenues</i>
1988	8.1	1.9	6.7	0.7	18.3
1989	8.3	1.9	6.7	0.6	18.5
1990	8.2	1.6	6.7	0.6	18.2
1991	8.0	1.7	6.8	0.7	18.0
1992	7.7	1.6	6.7	0.7	17.7
1993	7.9	1.8	6.6	0.7	17.8
1994	7.9	2.0	6.7	0.8	18.4
1995	8.2	2.2	6.7	0.8	18.8
1996	8.7	2.3	6.8	0.7	19.3
1997	9.3	2.3	6.8	0.7	19.8
1998	9.9	2.2	6.8	0.7	20.5

*Source:* Congressional Budget Office (1999).

rates) and how much of it is due to a discretionary fiscal adjustment. The difficulties in answering this question are several. First, the behavior of the economy may be influenced by fiscal policy; therefore, the effects of policy and the economy cannot be separated. Second, the baseline for a “normal” economy is controversial. Third, the methods of correcting for cyclical effects of various items of the budget varies with alternative hypotheses and procedures.

In any case, an intriguing (although rough) comparison is between the United States and countries of the euro area, many of which were going through fiscal adjustments in the 1990s. An interesting question is the following: What would have happened to the U.S. budget if the American economy had grown at the same rate as Euroland and had faced the same interest rates? One way of answering this question is to follow the procedure suggested by Auerbach (1994, p. 170, eq. 9). This expression shows how to calculate “the immediate, permanent reduction in the primary deficit . . . that if projections prove accurate, would be needed to bring the debt/GDP ratio at some date  $T$  in the future down to some initial level  $t$ .” Using this formula, I calculated how much bigger the reduction of the primary deficit/GDP ratio in 1993 would have needed to be to achieve the 1998 level of the debt/GDP ratio, if the spread between the interest rates and the growth in the United States had been the same as that of an average of the current eleven members of the European Monetary Union.<sup>9</sup> The average spread between long-term real interest rates and the growth rate in the countries that joined the European monetary union was about 3 percent; the same spread in the U.S.

<sup>9</sup> These countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

economy was 1 percent.<sup>10</sup> I chose 1993 because this is a turning point when the debt/GDP ratio in the United States stopped growing, and this is the year of the Omnibus Budget Reconciliation Act of 1993.

The answer is that if the U.S. economy from 1994 to 1998 had performed like the economy of Europe, then the United States would have needed to have an additional permanent reduction in the deficit/GDP ratio of about 1.3 percentage point starting in 1993 to achieve the actual debt/GDP ratio that was reached in 1998. Europe was not doing too well economically in the 1990s, so this figure may be an upper bound, but it highlights how much the strong U.S. economy helped its fiscal improvement. As a matter of comparison, the primary deficit in the United States fell by about 1.2 percent in 1994, the year after OBRA, according to OECD data. Given the strong economy of 1994, a portion of this effect is due to the cyclical effect of GDP growth, beyond OBRA.

What about the future? For how long will surpluses accumulate? In a series of papers on fiscal adjustments in OECD economies, I have argued that fiscal adjustments which do not tackle the dynamic of entitlements are not long-lasting and tend to be reversed, simply because tax revenues cannot keep up with the growth of mandatory spending (Alesina and Perotti, 1995b, 1997; Alesina and Ardagna, 1997; see also Ardagna, 1999). Looking at the international evidence, one of the strongest indicators of whether a fiscal adjustment is long-lasting is the share of the deficit reduction obtained by stopping the growth of entitlements. In the same spirit, Auerbach (1994) argues that the Omnibus Reconciliation Act of 1993 did not provide a long-run fix for the budget, but only a short-term benefit which would disappear in the medium run.

The Congressional Budget Office (1999) has provided a very optimistic forecast on the accumulation of budget surpluses in the next decade.<sup>11</sup> The CBO predicted that surpluses will continue to increase in the next three years, reaching about 3 percent of GDP in 2009. As required by law, these forecasts are based upon a legal definition of unchanged legislation. However, from an economic point of view, these predictions vastly overestimate the surpluses. The CBO assumed that the spending caps imposed by the Deficit Control Act of 1997 will remain in place and will be fully implemented. Given the “emergency spending” in the Omnibus Consolidated Emergency Supplemental Appropriation Act of 1999 that added \$21.4 billion of dollars to 1999 discretionary spending, the CBO predicted that until 2002, various cuts will compensate for this extra spending. This implies that discretionary spending will have to decline in *nominal terms* until 2002, falling from \$575 billion in 1999 to \$568 billion in 2002. After 2002, discretionary spending is expected to increase at the rate of inflation. These projections about spending lead

<sup>10</sup> To maintain comparability between United States and Europe I used OECD (*Economic Outlook*, June 1999) data for these calculations. More details are available from the author.

<sup>11</sup> The statistical work underlying this paper was performed in August 1999, and used the latest CBO forecasts available then.



to a predicted reduction of discretionary spending from 6.6 percent of GDP in 1999 to 5.0 percent in 2009.

It is virtually impossible that the current spending caps will be enforced in a decade of budget surpluses. First, it is hard to imagine that defense spending can continue to fall at the same rate of the 1990s. The “peace dividend” is pretty much a one-shot event associated with the collapse of the Soviet bloc, and as noted earlier in Table 1, defense spending as a share of GDP is about half of what it was in 1988. Therefore, the reduction of 1.6 percent of GDP in discretionary spending envisioned by the CBO would need to come largely from cuts in nondefense spending. If defense spending remains roughly constant as a share of GDP, the predicted cut in discretionary spending would require halving discretionary domestic spending as a share of GDP. This is very unlikely to happen. The additional \$21.4 billion of discretionary spending in 1999 was “the highest level of emergency spending enacted in the 1990s, excluding spending for the Persian Gulf War” (CBO, 1999). Different readers may disagree about whether all the items of this bill were truly “emergencies.” The point is that in a period of surplus and spending caps, the definition of an “emergency” will almost certainly become quite relaxed. To put it differently, the CBO projects into the future a legislation which has the nature of a single, unique legislation implemented in a period of fiscal adjustment. In addition, a one-shot “peace dividend” is projected into the future.

A more economically meaningful baseline of “unchanged policies” is one in which discretionary spending increases at the same rate of GDP. Under this much more reasonable assumption that discretionary spending will remain at the same share of GDP in the next decade, the size of the surplus in 2009 is roughly halved, from 3 percent of GDP to about 1.5 percent, even without taking into account that a slower reduction of the debt/GDP ratio implies a slower reduction of interest payments (for given interest rates). The CBO also assumes that tax revenue as a share of GDP will remain roughly constant. If even a fraction of the tax cuts discussed in Congress are passed, this baseline assumption is very optimistic.

The CBO assumptions about interest payments are, by implication, also quite optimistic. Interest spending is expected to fall from 2.3 percent of GDP in 1999 to 0.6 percent in 2003, as a result of low interest rates and the rapid reduction of the stock of debt. Given the large surpluses that the CBO predicts, the debt held by the public is predicted to fall sharply, reaching less than 10 percent of GDP in 2009. However, if surpluses accumulate less rapidly, the stock of debt will decline more slowly and interest payments will remain a higher fraction of GDP than what was predicted by the CBO. The CBO’s predictions about interest rates appear reasonable, but since they are consistent with the hypothesis of a large drop in outstanding government debt which may not materialize, the interest rate projections are probably on the optimistic side.

In summary, under the realistic assumption that discretionary spending will not decrease much as a share of GDP, and that a small tax cut will be implemented in the next few years, the projected surpluses are less than half of the much-publicized forecasts of the CBO. In fact, even half of what the CBO predicts appears



as a rather optimistic forecast. If one considers a time horizon beyond 10 years, the optimism about surpluses have to be toned down even more. As Auerbach (1994, 1997) forcefully pointed out, because of the effects of the aging generation of the “baby boomers” on Medicare, Medicaid and Social Security, the U.S. budget is, in the long run, in deficit, rather than in surplus; that is, in order to prevent the debt/GDP ratio from increasing in the next few decades, one would need an increase in the surplus well beyond the already optimistic predictions of the CBO. As pointed out in Table 1, the rapid growth of Medicare and Medicaid is already happening, and the growth of Social Security spending will appear as the “baby boomers” retire.

## **What To Do With the (Alleged) Surpluses?**

First, I briefly discuss how economic theory would answer the question of what to do with the budget surpluses, and then I will analyze the politics surrounding it.

### **The Economics of Surpluses: Implications from Theory**

Given the discussion of the previous section, the theorists’ answer to the question of what to do with the surplus is simple: retire outstanding debt. Two arguments support this view: first, debt should be issued in recessions and retired in booms according to tax smoothing; second, current surpluses follow the excessive deficits of the 1980s. The argument for a temporary tax cut is weak, given the current state of the U.S. economy. More generally, the use of discretionary fiscal policy for fine-tuning is highly questionable, due to the “long and variable lags” argument. An argument for a permanent tax cut should ultimately rely on two grounds: Either spending is or is expected to be permanently lower; or economic growth is permanently higher, so lower tax rates will generate higher revenues.<sup>12</sup> I have serious doubts on both assumptions.

In any event, the point is that an argument in favor of a tax cut should be largely unrelated to the current temporary surplus. In fact, the effect of the future retirement of the baby boomers implies an expected *increase* in outlays for the government, at unchanged legislation. This effect calls for a permanent tax *increase*, rather than a tax cut. Obviously, legislation can change. Therefore, a different and interesting argument suggests using the surplus to finance tax reforms, particularly Social Security reforms. This issue is discussed below.

The criticisms directed to the proposals of using the surplus to cut taxes apply, in reverse, to proposals for spending hikes. Whether or not one favors more domestic spending, it is simply incoherent to argue that the current temporary surplus can support new spending programs, which, regardless of the intentions of the legislators, most often become permanent. Given the structure of the dynamic

<sup>12</sup> I do not even consider a Laffer curve argument, according to which lower tax rates would produce higher revenues automatically.

of spending discussed above, any proposal for more domestic discretionary spending requires a statement about how to finance it, either with higher taxes, or lower spending for entitlements, or more borrowing (that is, more taxes later) or a combination of the above.

### **The Politics of Surpluses**

In many respects, the political economy of surpluses is similar to the political economy of deficits. In both cases, various lobbies, factions, pressure groups, and their representatives fight over the allocation of the costs of adjustment (in the case of deficits) or the benefits of the common pool of resources (in the case of surpluses). In different countries and at different points in time, political institutions are more or less capable of coordinating these pressures into a coherent and sound fiscal policy.<sup>13</sup>

The academic literature has pointed out that the fragmentation of a political system is an obstacle to the implementation of the appropriate fiscal decisions, particularly when various shocks require a swift fiscal response. In the most general sense, political fragmentation is a situation in which many political groups have a voice in fiscal decisions, and many have veto power.<sup>14</sup> The point is not that fragmentation necessarily creates budget deficits, but that fragmentation creates obstacles to policy changes, because it becomes more difficult to reach agreements about corrective fiscal measures. For example, the British political system is non-fragmented, since, by design, the same party controls the executive and legislative branches of government. Interestingly, despite Britain's less-than-stellar economic performance since World War II, the United Kingdom is not a country with a debt problem. At the end of World War II, the United Kingdom had a debt/GDP ratio of more than 250 percent. Currently it is around 60 percent, one of the lowest in Europe, and the United Kingdom was not one of the countries in danger of not making the fiscal criteria for joining the European Monetary Union, although it opted out. On the other extreme, countries with large and fragmented coalition governments have not managed to quickly adjust to the shocks of the '70s, and have accumulated very large debt. The best examples are Belgium and Italy, two countries with fragmented political systems, and whose debt/GDP ratios are currently well above 100 percent. These two countries were almost not admitted in the European Monetary Union because of their poor fiscal performance.

Divided government is the U.S. version of the coalition governments of parliamentary democracies. It is defined as any situation in which the same party does not hold the presidency, the House of Representatives, and the Senate. Several observers have attributed the deficit of the 1980s to a fiscal deadlock caused by divided government (for instance, McCubbins, 1991). However, it is far from clear that divided government in the federal government has created budget deficits.

<sup>13</sup> For a discussion of political models of fiscal adjustments, see Alesina, Perotti and Tavares (1998).

<sup>14</sup> For theoretical work on this point, see Alesina and Drazen (1991). For empirical work on a cross section of countries, see Roubini and Sachs (1989) and Perotti and Kontopoulos (1998).

Other periods of divided government at the federal level have not systematically produced deficits; in fact, the budget was balanced at the end of the 1990s in a period of divided government.

Evidence gathered concerning fragmentation and budgets at the state level has a different tone. States with divided governments have tended to delay the adjustment to negative fiscal shocks relative to states with unified governments (Poterba, 1994; Alt and Lowry, 1994). Even positive fiscal shocks—like unexpected higher tax revenues—have created fiscal deadlocks and delayed legislation in states with divided governments. This finding hints that the politics of deficits and surpluses are similar. In both cases, negative or positive fiscal shocks generate a similar political battle: Who should pay for the deficits in one case and who should benefit from the surpluses in the other?

An interesting question is whether in a situation of divided government, which is becoming more and more the rule rather than the exception in the United States, these battles over the budget are more or less likely to result in what Niskanen (1997) labeled “an incoherent mishmash of small spending increases and tiny tax cuts.” Neither of the two American parties is immune from pork barrel politics. However, the balance provided by divided government may help avoid the most egregious deals to some extent. On the other hand, divided government may create an obstacle to the adoption of a coherent fiscal plan, if the latter is the result of a badly worked out compromise between conflicting plans of an administration and a Congress not held by the same party. In other words, relative to unified government, divided government offers more moderation and checks and balances, but also it creates the risk of fiscal confusion; in this case, a proliferation of uncoordinated bills leading to a waste of the temporary surplus without addressing the long-run fiscal deficits of the Social Security system.

The early stages of the discussion of what to do with the budget surplus show elements of both the positive and the negative aspects of divided government. Both parties have kept doors open to pork barrel politics. Debates in Congress often show examples of proposals for favors to various constituencies.<sup>15</sup> On the other hand, the extreme proposals on each side of the political spectrum will face opposition in one of the two branches of government, if the latter is divided. A Democratic president would veto the most extravagant tax cutting proposals from a Republican House. If a Democratic administration wanted to spend the surplus in domestic programs, a Republican House would object. This is precisely why American voters do not view divided government as an “accident,” but a way of enforcing centrist policies.<sup>16</sup>

Beyond the standard battle over pork barrel favors, a few general themes about the use of the surplus have taken shape. Three kinds of general proposals have emerged.

<sup>15</sup> For humorous descriptions of some of the pork barrel proposals discussed in Congress, see several issues of *The Economist* magazine in July–August 1999.

<sup>16</sup> See Alesina and Rosenthal (1995) for an extensive theoretical and empirical discussion of this point.

1) *Cut taxes across the board.* Republicans in the House and the Senate have been pushing for major tax cuts, the biggest since those of the first Reagan administration. These cuts range from very broad-based ones, like proportional reduction of income tax rates, to more specific items of the tax code, like the inheritance tax. The philosophy underlying these proposals is that even through the first-best fiscal policy may call for retiring debt, current or future Democratic legislators and presidents are likely to spend the surplus in “wasteful” domestic programs, if surpluses continue to materialize.<sup>17</sup> Given this political constraint, the second-best policy for a fiscal conservative is to reduce fiscal revenues available to big spenders.

This idea cannot be easily dismissed, if one looks back at the 1980s. The Reagan plan of tax cuts and spending reductions—more of the former than the latter—gave rise to substantial deficits.<sup>18</sup> Once the deficits materialized, the Republicans both in the administration and in Congress held their ground against major tax increases. Many observers noted that, in the end, the deficits would have imposed a binding constraint on spending, an outcome at least non-disliked by many conservatives. A similar view briefly reemerged during the Dole presidential campaign of 1996.

From the point of view of someone who believes that government is too big, the policy of cutting taxes in order to “force” spending cuts in the future is reasonable, if not pushed to excess. Persson and Svensson (1989) and Alesina and Tabellini (1990) provide a model consistent with this implication. A “conservative” policymaker, opposed to the growth of domestic spending programs, may choose to abandon fiscal balance and let public debt accumulate. Future “liberal” governments will have to use a relatively large fraction of tax revenues to service the debt and they will be limited in the amount of tax revenues they can use for domestic spending. From the point of view of the conservative government, the cost of abandoning tax smoothing is more than compensated for by the constraint imposed on domestic spending. More generally, if one believes that institutional failures lead to an upward bias in spending levels, then a policy of tax cuts balances this distortion. One reason why spending might have an upward bias, for example, is related to the incentives of legislators to concentrate benefits of pork barrel projects in their districts, without internalizing the costs of taxation, which are spread across multiple districts.<sup>19</sup>

The Reagan deficits of the 1980s certainly contributed to a subsequent reductions of the size of government, measured as noninterest spending over GDP. If the Clinton administration did not face a deficit problem, spending caps probably would have not been imposed and it is quite likely that discretionary spending

<sup>17</sup> See Talvi and Vegh (2000) for a model that characterizes the effect of fiscal policies when surpluses automatically fuel spending.

<sup>18</sup> For a discussion of the reasons why the deficits increased in the early 1980s, see the contributions by Poterba, Stockman and Shultze in Feldstein (1994a).

<sup>19</sup> See Alesina and Perotti (1995a) for a survey and Milesi Ferretti, Perotti and Rostagno (2000) for some recent empirical evidence on spending biases in different institutional systems.

would not have remained constant. If a relatively large fraction of fiscal revenues had not been needed to service the debt accumulated in the 1980s, there would have been more room for spending in the 1990s. In other words, the argument that “if fiscal resources are available, they are spent” implies, logically, that the only way of enforcing spending cuts is to lower taxes. This is the “Starve the Leviathan” policy.

The Achilles’ heel of these proposals is that, realistically, the only way to cut spending significantly in the long run is to do something about Social Security. Republican advocates of major tax cuts are typically not in the front line amongst the advocates of cuts of Social Security benefits.

The current proposals of the Clinton administration do not show a tendency to large increases in discretionary spending, but favor repaying the debt. However, conservatives argue that after a display of “moderation” in an election year, the true spirit of the big-spending Democrats will resurface. The idea of restraint of spending in election years is exactly the opposite prediction of the traditional “political business cycle” of Nordhaus (1975). This observation simply shows that Nordhaus’s model offers only a partial view of the political process. In fact, the Democratic party, sensitive to accusations of lack of fiscal restraint, is moving toward the political middle of the road on fiscal issues.<sup>20</sup> Republicans argue that this moderation will not last long after the election.

2) *Use the surplus to finance more discretionary domestic spending.* This proposal, although not explicitly advocated by the Clinton administration and even less by Congress, has some support; see for instance, Reich (1999), Eisner (1998) and Baker (1998). These authors, amongst others, favor the use of surpluses to finance public investments in education, infrastructure, and so on.

Given the budget arithmetic discussed above, the view that many resources are available to increase domestic spending without raising taxes is simply incorrect. In fact, the argument for using current (temporary) surpluses to finance permanent spending hikes has the same flaws of the argument for permanent tax cuts. It may very well be true that current level of spending in education, infrastructure, poverty alleviation programs, and so on are too low. This does not mean that spending in these areas can be increased without either cutting some other forms of spending or increasing current taxes or future taxes (after issuing current debt). Advocates of more discretionary spending are not amongst those who favor cuts in entitlements, and almost nobody in the United States seems to favor higher taxes, at least openly.

Proponents of the “increase spending” argument may, in fact, be perfectly aware of the budget arithmetic, but they may have in mind the reverse of the “Starve the Leviathan” argument. They hope that once in place, new spending programs will create constituencies who favor them so that the fiscal resources necessary to finance them will be found, eventually.

3) *Use the surplus to finance Social Security reforms.* Any reform of the Social

<sup>20</sup> For models consistent with the view that parties display “moderation” in election years and then if elected, show their “true” nature, see Alesina and Rosenthal (1995, 2000).

Security system which moves it from a “pay as you go” system to a “fully funded” one implies transitional costs for the current generation. In Diamond’s (1999, p. 4) words: “[S]ignificantly improving the financial value of Social Security for future generations would come at the costs of worsening the financial value of Social Security for current generations or would require that general revenues be devoted to Social Security.” A hypothetical social planner would optimally trade off the costs for the current generation against the benefits for the infinite future, but in all political systems, the current generation has more voice than future, unborn generations. This essay is not the place to discuss alternative proposals for Social Security reform in any detail; the concern here is simply to sketch different implications for the budget surplus. Without such reforms, the costs of Social Security will begin to exceed payroll revenues by about 2013, and within a few years of 2032, the current trust fund would be bankrupt.

One side of the range of Social Security reform proposals would maintain the current “pay as you go” system and further increase the “advance funding” in anticipation of future solvency problems. This is largely the approach of the Clinton administration. Critics of this proposal argue that “there is a significant chance that some future Congress would use at least some of the funds to increase benefits or reduce taxes or possibly spend them for other purposes” (Diamond, 1999, p. 99). Note that this is the same logic underlying the “Starve the Leviathan” logic of tax cut proposals. In fact, on the Republican side, critics argue that President Clinton’s proposal for “saving Social Security” is a ploy to collect more revenues and to avoid scaling down the size of government.<sup>21</sup>

One could pass legislation geared toward preventing the use of the Social Security trust fund for other purposes, but this kind of “binding” legislation can often be circumvented, at least up to a point. One example of this type of legislation would be a complete separation of the Social Security budget from the rest of the budget as advocated, for instance, by Munnell (1998). This step might avoid using the Social Security surplus for discretionary spending, but it would not avoid increasing Social Security benefits for current generations of voters at the expense of future generations.

An alternative type of proposal is to use the current surplus to finance the transition to a broader adoption of personal retirement accounts of the 401(k) type. Feldstein and Samwick (1997, 1999) and Feldstein (1999b) have put forward a specific proposal along this line. The idea is that individuals would receive a 2.3 percent tax cut on income up to the Social Security earning limit (currently around \$68,000) on the condition that the tax cut is saved in a Personal Retirement Account (PRA). An individual who reaches retirement age can then withdraw payments from the PRA. Individuals’ Social Security benefits would be replaced by 75 cents for every dollar of PRA withdrawal. Feldstein and Samwick (1999, p. 3) calculate that financing this scheme would cost about 0.9 percent of GDP in tax

<sup>21</sup> For a specific discussion and criticism of the Clinton administration’s plan for Social Security, see Feldstein (1999a).

revenues, “less than the currently projected budget surpluses.” Actually, with the more realistic projections about the surplus discussed earlier in this paper, the cost of this scheme may exhaust all the available surplus. As Feldstein (1997) noted, “[I]f the near term surpluses are too optimistic, the PRA tax credits could push the budget into deficits.” In any case, even in the most optimistic scenario, a temporary tax increase will be needed at some point to finance the full transition to PRA accounts. From a tax-smoothing point of view, a temporary deficit incurred to help finance a future large increase in spending is appropriate, especially if the temporary deficits also serve the purpose of reducing future outlays.

Leaving aside a broader discussion of the pros and cons of how to structure individual retirement accounts, including the transaction costs of such accounts and how much freedom individuals would have to invest their money in different ways, this general type of reform would create a more solid commitment to use the surplus to “save Social Security” than simply increasing the trust fund. In addition, this kind of proposal may be politically palatable, since it combines an element of tax cut, favored by many Republicans, with an element of “using the surplus to save Social Security,” an argument favored by the Clinton administration. A standard criticism of these proposals is that individuals may reduce other sources of savings if they receive this tax cut linked to forced savings. The reply of the proponents is that the savings rate of most recipients of this scheme is so low already that it is unlikely to offset the forced saving induced by the scheme. Also, they argue that the change in the time profile of disposable income may actually increase savings. Finally, different solutions to the Social Security problem, with or without individual accounts, have different distributive implications. The current surplus may help to “smooth” distributional flows during the transition.

## **What is Ahead?**

Current budget surpluses have been achieved mainly thanks to a combination of an exceptionally strong economy, low interest rates, and large cuts in the defense budget as a share of GDP. The current surplus will create political pressure for tax cuts and spending increases, even though the expected growth of entitlements in the next few decades raises serious doubt on the long-run fiscal balance. Even in the most optimistic scenarios about how Congress and the president will coordinate these demands, the surpluses in the next decade are likely to be much smaller, probably less than half, than what is predicted by the CBO, with unchanged legislation. Almost certainly, pork barrel politics will dissipate part of the surplus in “favors” to various constituencies. What will happen to the rest of the surplus will depend on how the political game unfolds after the November 2000 election. Whoever is in office in the next decade will have to face the growth of Medicare, Medicaid and the effects of the baby boomers on Social Security. The current surpluses offer an opportunity to help in achieving a solid long-run balance of the government budget. Seizing this opportunity will require careful and prudent



policies, not just a reliance on the miracles of the “new economy,” which eventually, will look more and more like the old one, with its cycles and downturns.

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