UNITED STATES SENATE
REPUBLICAN
POLICY COMMITTEE

Larry E. Craig, Chairman
Jade West, Staff Director

September 23, 1997

Liberals' Spending Threatens Balanced Budget

Counting Chickens Before They Hatch

The ink was not even dry on the Balanced Budget Act (BBA) and Tax Reform Act before liberals began spending the "savings" -- $49 billion over five years in additional entitlement spending in the BBA itself. Now with the new, more optimistic deficit estimates from the Congressional Budget Office (CBO) and the Administration's Office of Management and Budget (OMB), the dollar signs are dancing before their eyes again. As just one example of the liberals' desire to spend money instead of achieve a surplus, consider that House Minority Leader Gephardt suggested that balancing the budget was "a mistake" and "unnecessary," and instead offered a different priority: "more public investment in resources" [*St. Louis Post-Dispatch*, editorial, 7/16/97]. Ironically, the very legislators who most opposed balancing the budget are the ones first in line to reap its rewards.

The only problem is this: There is no "surplus." At least, not until 2002 -- the same year originally projected -- according to both CBO and OMB in their latest estimates. But, more importantly, even then, there will be no "surplus" if Congress resumes liberal spending now.

What the latest estimates show is not more money to spend now, but simply lower deficits than originally projected between now and 2002. Yet even this more optimistic projection rests on several crucial and interconnected assumptions (the first being the most critical):

- That Congress stays on the balanced budget course it just set
- That the economy continues to perform well -- particularly in generating revenues
- That existing mandatory federal spending doesn't begin to rise before expected

Nothing in this paper intends to imply that the budget will not balance by 2002 or that it would not begin running surpluses after that, as is now widely projected. What is suggested here is that the surest way to undo our promise to America is to allow more spending. Any surplus, whenever it occurs, should be protected from the liberals and for the taxpayers from whence it came.

The Deficit: Shrunk, But Not Yet Eliminated

CBO and OMB released their latest deficit estimates earlier this month. Both show substantial improvement in the deficit from the earlier May estimates that were used during balanced-budget negotiations. September's deficit outlook reflects the longer-term improvement that has been taking place as the economy continues to out-perform expectations and mandatory federal spending continues below expectations.

Deficit Estimate Comparison Chart (PDF format)

- The FY97 deficit estimate has fallen from $115 billion in March to $67 billion in May to $34 billion according to CBO, and to $37 billion according to OMB. That's down from $107 billion in FY96.

- The FY02 estimate has gone from deficit to surplus following the policy changes in the BBA and TRA. CBO's FY02 deficit estimate was $188 billion in March, and $139 billion in May, and became a $1 billion surplus under the BBA and TRA policy assumptions, most recently rising to a surplus of $32 billion according to CBO, and of $64 billion according to OMB.

- The FY07 estimate has made an even larger improvement, going from CBO's $278 billion deficit in March to a $187 billion deficit in May. Then, after the BBA and TRA, the projection became a surplus of $34 billion, and, as of September, the surplus is projected to be $86 billion according to CBO, and $167 billion according to OMB.

Liberals hastily and imprudently have grasped this deficit-improvement picture as a "surplus" that is now available for spending. Not so. The first and most important fact is that the budget will not reach balance until FY 2002 -- the same year as originally projected. For the next four years, the budget will continue to run deficits, albeit smaller ones. Anyone proposing more spending anytime between now and 2002 is simply proposing more deficit spending -- even if they call it an "investment."

- In May, projected deficits between FY98 and FY02 amounted to $595 billion. Even after assuming the policy changes in the balanced budget agreement reached between Congress and the President, the deficits were projected to amount to $315 billion.

- Following September's more favorable estimates, the deficits between FY98 and FY02 are projected to be $161 billion according to CBO, and $99 billion according to OMB.

While quantitatively different, there is no qualitative difference in what these estimates represent: Deficits. ***New spending would still be deficit spending between now and 2002.***

Congress Must Stay the Course to Get to Surplus

Nor do future "surpluses" allow for future unfunded new spending. The presently-projected surpluses are the results of policy changes. Changing the "change" -- i.e., returning to liberal spending rather than sticking with fiscal discipline -- will help ensure surpluses never materialize. Recall that Congress merely has taken the first step toward balancing the budget. Although the eggs are in the nest, the chickens have not yet hatched.

CBO had this to say about the importance of the policy change represented by BBA and TRA: "The reconciliation legislation changes the projected path of the deficit from one of annual increases to one that hovers near zero for the next 10 years" [CBO, "The Economic and Budget Outlook: An Update, September 1997, p. xiv].

- The policy changes in BBA and TRA resulted in $118 billion in deficit reduction from FY98 to FY02. Because it takes time for policy changes to take effect, 80 percent -- $95 billion -- of the overall deficit reduction will take place in FY02, according to CBO.

- Much of the deficit reduction -- $88 billion of the $195 billion in CBO's estimated spending reductions from FY98-02 -- will be realized through savings from so-called "discretionary spending" -- that spending which Congress annually appropriates. Since this is done on a yearly basis, the savings can only be made if Congress sticks to its promise of fiscal discipline.

Even if liberals want to make use of a "buy now, pay later" scheme where the full costs of programs would not materialize until 2002 and later, the effect of doing so would undermine the fiscal discipline that must be continued if the "surpluses" are to be realized at all.

The Economy: A Major Force on the Road to Budget Surpluses

The indirect effect of Congress' actions on the economy are just as important to balancing the budget as is the direct effect. Much of the improvement in the deficit outlook has come from the performance of the economy -- especially through lower interest rates and higher revenues. This private-sector boost, the so-called "fiscal dividend," has been taking place even earlier than expected, as the private sector has responded to good overall economic climate of strong growth, stable monetary policy, and the fiscal discipline in Washington. The interplay of these factors will determine whether there is balance by 2002 and a surplus in later years.

How important is the economy to eliminating the deficit?

- According to CBO over the FY98-02 period, economic and technical changes account for $517 billion in deficit reduction since the March estimate. Policy changes account for only $118 billion over the same period.

- According to CBO, over the "surplus period" FY02-07 economic and technical changes account for $1.107 trillion in deficit reduction since the March estimate. Policy changes account for $572 billion over the same period.

- According to CBO, over the entire FY98-07 period, economic and technical changes account for $1.499 trillion in deficit reduction since the March estimate. Policy changes account for $595 billion over the same period.

Economic health is obviously fundamental to eliminating the deficit. The economy has responded very favorably to the fiscal policies in Washington and the prospect that these policies will continue. CBO notes that "the growth dividend that stems from assuming a balanced budget accounts for about one-third of the upward revision" that it made to its projections, and that "relatively low deficits for the next few years and small surpluses in the beginning of the 21st century would cause the federal government to draw substantially less from private credit markets than it has in recent years." [CBO Update, pps. 21, 27]. That means low, and lower, interest rates which are a boon to the economy. The performance of interest rates bears out the beneficial effects of the current fiscal course.

- Since November 1994, when Republicans took control of Congress, interest rates have fallen from 8.04 percent to 6.37 percent (9/19/97) on the 30-year Treasury bond.

- Correspondingly, since the end of 1994, the Dow Jones Industrial Average had doubled, rising from 3834 to 7917 (9/19/97).

- CBO expects rates to fall further -- to 5.7 percent on the 10-year bond in 2000.

Yet, it can be anticipated that if liberals were to succeed in implementing policies either to increase deficit spending prior to FY02 or to spend the surpluses in FY02 and the following years, the private sector would react negatively. Rates would increase, which would in turn have a negative effect on the economy's performance and federal revenues.

Specifically, deficit improvement depends mightily on revenue growth, as is shown by CBO's estimates: "Of the $81 billion drop in the estimate, $71 billion stems from higher revenues and the remaining $10 billion from lower outlays" [CBO Update, p. x]. Revenues will grow 55 percent from FY97-07, while spending will grow just 46.5 percent. On a per-year basis, revenues will grow 4.58 percent versus 3.78 percent for spending from FY98-07. Together BBA and TRA balance the budget by allowing revenues to out-grow outlays. Liberal spending doubly endangers that dynamic by both lowering revenues and increasing outlays.

And future revenue growth is already expected to be under pressure:

- "CBO does not foresee revenues continuing to grow at the rapid pace of the past few years, largely because the 1993 tax increase is completely phased in..." [CBO, p. 29].

- The economy also will slow: "CBO estimates that the U.S. economy has been operating above potential since the second quarter of 1996..." [CBO, p. 4]. In fact, real GDP growth has been above 3 percent for the last four quarters. Hence, CBO expects real GDP growth to be "slower in 1998 than in 1997, while inflation and short-term interest rates will be higher" [CBO, p. 16] with the growth projected to be just 2.3 percent from 1999-2007. OMB echoes this outlook: "At this stage of the expansion, pent-up demand for consumer durable goods stemming from the last recession has largely been exhausted. . . . Housing starts [will] return to levels consistent with long-run demographic trends. Finally, the Administration expects the recent rise in the dollar to restrain the growth of net exports for some time to come" [OMB, "Mid-Session Review of the 1998 Budget," p. 8].

With the economy already expected to weaken, it is especially vulnerable to an increase in interest rates that would occur if the government increases its borrowing prior to 2002 or even if financial markets sense that the federal government is not serious about maintaining fiscal discipline in the future and lenders begin to raise long-term rates in anticipation. Increased interest rates due to a lack of confidence in Congress' resolve -- on top of a weakening economy -- could have a devastating effect, "enough to heighten the possibility of an economic contraction in late 1998 or 1999." CBO notes that a recession "could push the deficit above current projections by $100 billion or more for several years" [CBO, pps. 3, ix]. With the financial markets posed to raise interest rates in response to latent inflation, the worst thing Congress could do is to add impetus to this by increasing spending.

Temporary Surplus At Best

On top of all these factors that should dissuade Congress from liberal spending, add to the fact that the projected surpluses are temporary at best.

- "Although the surpluses are projected to grow modestly larger through 2007, large budget deficits will emerge again as the baby boomers retire unless the fiscal pressures from Social Security, Medicare, and Medicaid are resolved" [CBO, p. 13].

- "In 2008, the first of the baby boomers will turn 62 years old and thus become eligible to claim early retirement under Social Security. Three years later marks the start of their participation in Medicare. . . . Without further action to restrain the growth of those entitlement programs, a deficit is likely to appear sometime thereafter" [CBO, p. 29].

- To understand just how great this pressure is, consider that even after BBA's $373 billion mandatory-program policy changes, mandatory spending still will increase from $902 billion in FY97 to $1.609 trillion in FY07 -- a 78-percent increase -- and it will grow from 56 percent of all federal spending to 68 percent in that same time.

Standing Between Liberals and New Spending: The Law

Fortunately, two budget enforcement rules stand between liberals and new uncontrolled spending: spending caps and so-called "PAYGO" offset requirements. Under the old Gramm-Rudman-Hollings law, where deficit totals were set and enforced by sequestration (across-the-board cuts in all except specifically exempt programs), there was not protection against additional spending.

This demonstrates the limitations of attacking the deficit and is the reason why that tactic has been abandoned in favor of attacking the spending under the Budget Enforcement Act of 1990 (BEA). Rather than addressing the effect, the budget law now controls the cause: uncontrolled spending. It does so in two ways. First, it establishes explicit limits on discretionary spending using spending caps; second, it requires that new mandatory spending must be paid for -- either offset with spending cuts or with tax increases that equal the new spending. Both these requirements are enforced in Congress by points of order -- with 60 votes needed to waive these in the Senate. If these two procedures still fail to keep spending in check, the excess amount is subject to an across-the-board sequester (with certain programs exempted).

The spending caps and PAYGO offset requirements of the 1990 BEA were extended once again (earlier extended in 1993 through 1998) -- this time through at least 2002 to conform with BBA's deficit-elimination goal. And so, even if new liberal spending were desirable, it could not be either procedurally or legally accommodated unless the legal caps were either raised or the new spending offset with equal spending reductions.

The Best Course: Preserving the Surplus for the Taxpayer

The latest reports show the deficit has declined, not been eliminated -- at least not until 2002. Because of the complex policy, economic, and technical interactions involved, the surpluses predicted for FY02-07 are just that -- predictions.

To achieve real budget surpluses, Congress must stick to the commitment it made with the BBA and TRA -- not only because of the direct effect doing otherwise would have on the budget, but because of the indirect effect it would have on the economy. The worst course Congress could choose would be to spend a surplus that does not yet even exist. Congress' better course is to use any budget surpluses to fundamentally reform the nation's arcane anti-growth tax system. Not only would this be the only fair distribution of a surplus that Congress could make, it also would be the best investment of one.

Any surplus that does become realized belongs to the taxpayers, not to liberal spenders who never wanted a balanced budget or a tax cut in the first place.
