Published by

AMERICAN INSTITUTE
*for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

# RESEARCH REPORTS

Vol. LXVIII No. 5 March 12, 2001

## The Bush Budget Message

*Given the astonishing improvement in the Federal Budget outlook, the new administration had an opportunity to propose bold changes in a tax code that Jimmy Carter (accurately) described as "a disgrace to the human race." If President Bush's budget message provides any indication, however, that opportunity has been squandered.*

On February 27, President Bush presented his budget message to Congress. In contrast to his predecessors, he devoted more attention to the longer-term outlook and plans, and less to specific proposals for the upcoming fiscal year. Specifically, the President focused on three major uses for the Federal budget surpluses, currently projected to total $5.6 trillion through the end of fiscal 2011. These are: paying down the National Debt ($2 trillion), saving "the entire Social Security surplus" ($2.6 trillion), and tax relief ($1.6 trillion). According to the President, utilizing the projected surpluses in these ways will still leave $1.4 trillion for "additional needs and contingencies."

The amounts mentioned add up to $7.6 trillion or $2 trillion more than the projected budget surpluses. As discussed below, this is because the $2 trillion reduction of the debt held by the public is included in the $2.6 trillion "Social Security surplus" to be "saved."

### *The Baseline Budget*

The $5.6 trillion is the total of the surpluses projected in the current "baseline budget" of the Congressional Budget Office. This is based on various assumptions. These include a projected average annual increase in nominal GDP of about five percent over the 11 years 2001-2011, three percent "real" growth, and price inflation of two percent as measured by the GDP deflator and 2.6 percent as measured by the consumer price index over the same period. The budgeteers also project an average unemployment rate of 4.9 percent, as well as interest rates averaging 4.9 percent on 3-month Treasury bills and 5.8 percent on 10-year Treasury notes.

These assumptions generally reflect an outlook that is somewhat less favorable than the very recent performance of the economy, but better than the average of recent decades. The baseline budget also incorporates assumptions that there will be no changes in existing government programs, and that discretionary spending will only increase at the assumed rate of price inflation.

Even in the unlikely event that the economic assumptions prove to be accurate, the projected totals in the baseline budget are unlikely to bear much resemblance to the eventual outcome. This is evident in Charts 1 and 2 below, which show Federal receipts and outlays and the Federal surplus or deficit, and in Chart 3 on the following page, which shows Federal debt held by the public (all as a percentage of GDP).

Under the baseline budget, Federal outlays as a percent of GDP continue a steady decrease that began from the peak of 22.3 percent of GDP reached in the recessionary year of 1991 to 18.2 percent in fiscal year 2000. On the assumption of increases in discretionary spending only in line with price inflation, baseline out-

Chart 1
**Federal Receipts and Outlays as Percentages of GDP***

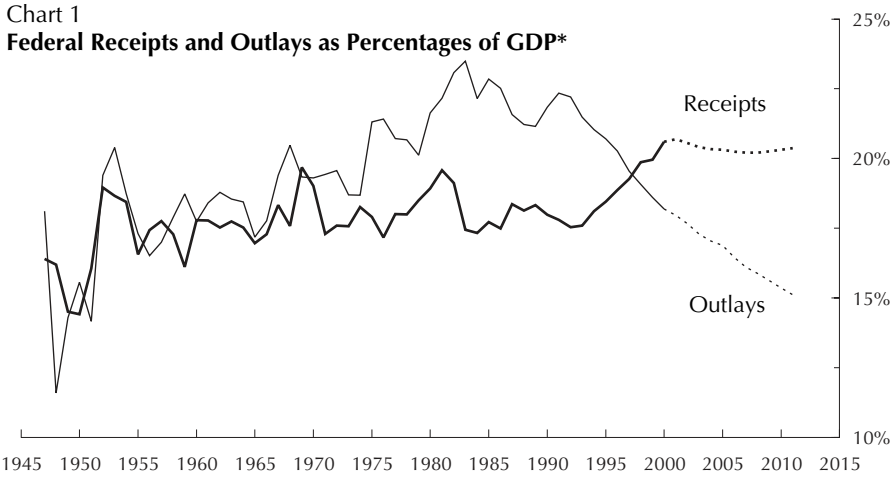
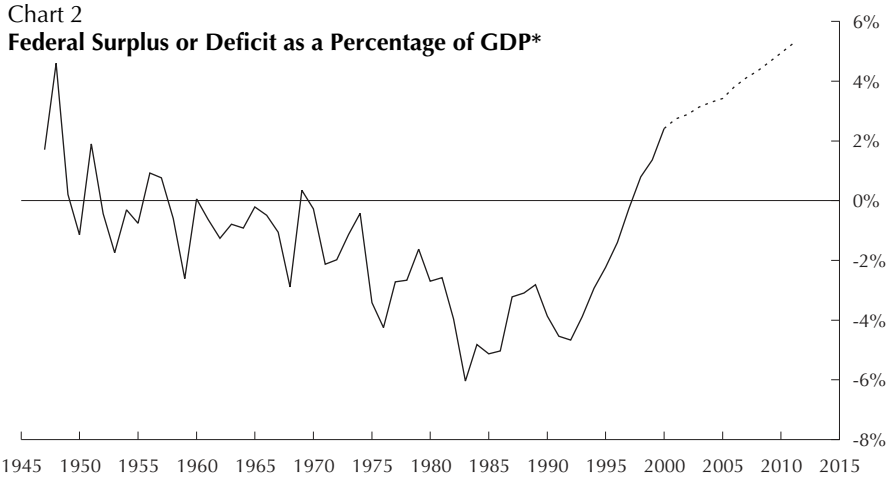
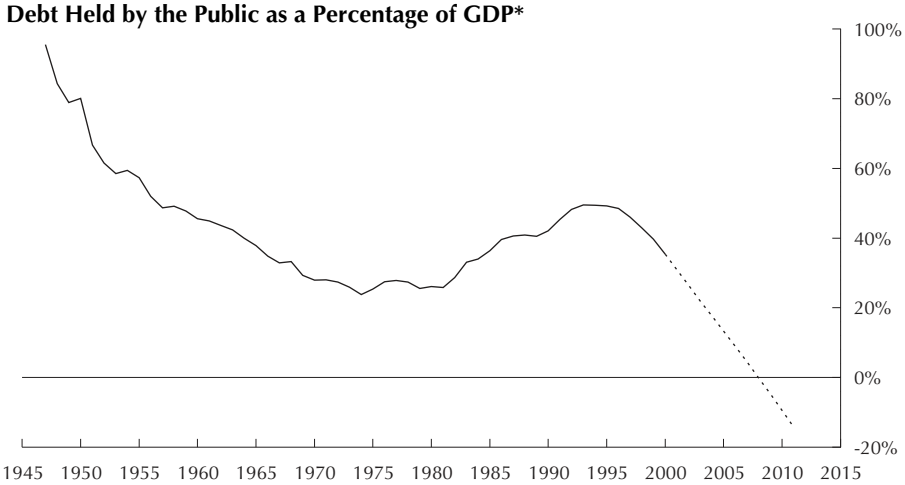



Chart 2
**Federal Surplus or Deficit as a Percentage of GDP***




* 1947-2000 Actual, 2001-2011 per "Baseline" Budget.
Source: Congressional Budget Office.

Chart 3
**Debt Held by the Public as a Percentage of GDP***




* 1947-2000 Actual, 2001-2011 per "Baseline" Budget.
Source: Congressional Budget Office.

lays decrease to a little over 15 percent of GDP in the year 2011. Even if all of the $1.4 trillion that President Bush says will be available for "additional needs and contingencies" is used for additional spending between now and 2011, Federal outlays would still average only a little over 17 percent of GDP during fiscal years 2002-2011. They have not been at that low level since the 1940s. Given that President Bush is already proposing some spending increases in excess of price inflation and that Congress is likely to have more ideas along such lines, it is not unreasonable to expect that by the time the books are closed on fiscal 2011, the Federal government will have spent much, much more than $1.4 trillion over the current baseline estimates.

Also, as the chart of the Federal surplus and deficit as a percent of GDP indicates, the baseline budget's surpluses would be unprecedentedly large. And, as the chart of the Federal Debt held by the public shows, the baseline budget calls for the U.S. Government to retire all its debts held by the public by 2007, and to begin acquiring financial assets (stocks? bonds? bank deposits?) thereafter.

### *Pay Down the Debt?*

Alexander Hamilton long ago recognized the utility of the National Debt. His initial refunding of the debt of the United States over 200 years ago was designed to help unify the young Nation and to provide a safe and secure investment for its citizens. The National Debt still performs the latter function as a "risk-free" investment. The rates of return on Treasury securities also provide yardsticks in economic and investment analysis, and they are used to set the rates on the Treasury's nonmarketable issues. The latter include Treasury issues held by Federal trust funds and some foreign official institutions, and savings bonds. Thus, there are some important reasons to maintain an active market for Treasuries.

Retirement of Treasury securities serves to reduce Federal interest expense. It is also often said to boost capital markets, but this would seem to be mainly a consequence of viewing economic activity through the Keynesian prisms of the National Income and Product Accounts, where government surpluses are treated as a form of savings. Historically, there is, if anything, an *inverse* relationship between the Federal surplus and deficit and interest rates.

We have thus far experienced only three years of Federal surpluses (fiscal 1998, 1999, and 2000). These three years have resulted in a paydown of more than $400 billion of Federal debt held by the public, to about $3.5 trillion as of last September 30. The current estimate of the surplus for fiscal 2001, the current fiscal year, is $236 billion, and President Bush is proposing a budget (with revenues decreased from the baseline by tax cuts and with spending above the baseline) that will produce an estimated surplus of $231 billion for fiscal 2002. At the same time that the Treasury has been reducing the amounts of marketable securities sold at its auctions, it has increased its issues of nonmarketable debt to its own trust funds. This shift from marketable to nonmarketable debt is expected to continue—and it is why President Bush's prospective retirement of $2 trillion of debt held by the public does not count as a use of the baseline budget's projected $5.6 trillion cumulative surplus through 2011.

There are now more than $1 trillion of Treasury issues maturing in 2003 and later years in the hands of the public. Such issues are noncallable. Neither are savings bonds, on which the Treasury owes more than $180 billion. More of both types of issues are likely to be issued before the end of fiscal 2002, when the total of Treasury Debt held by the public could be only a little more than $3 trillion. In addition, Federal Reserve Banks currently hold about $500 billion of Treasury securities for their own accounts and they hold another $700 billion on behalf of foreign central banks. These holdings comprise the major portion of the "backing" for U.S. paper currency and for a substantial portion of the paper currencies of the rest of the world. These holdings can also be expected to increase.

What all this means is that the Treasury can only pay down an additional $1 trillion or so before it, or the Federal Reserve for its own account or on behalf of foreign central banks, will become heavy investors in non-Treasury securities. The issues of Federal Agencies would seem to be the most likely candidates at first. But even there, direct official participation in private credit markets would no doubt become the object of political wrangling. Broader participation in other kinds of private debt issues would create even more political pressures and potential for abuses.

### *Social Security*

The $2.6 trillion mentioned by the President as saving "the entire social security surplus" would seem to be nothing more or less than Al Gore's infamous "lockbox." The $2.6 trillion is the current estimate of the excess of Social Security taxes over benefit payments and expenses (plus interest on the accumulated excess) for fiscal years between now and 2011, by which time the Social Security Trust Fund is expected to total more than $4 trillion.

Yes, Virginia, there is such a trust fund. It is located in West Virginia where, thanks to Sen. Byrd, there is an office that receives and keeps track of I.O.U.s that are sent there by the Treasury. One day the Secretary of the Treasury will begin paying off these I.O.U.s with the receipts from non-Social Security taxes or by genuine borrowing. We say "genuine" borrowing because the borrowing from the Trust fund and the holdings of Treasury I.O.U.s simply amounts to shifting money from one pocket to another.

From the perspective of taxpayers and for the economy as a whole what matters is the extent to which Social Security taxes exceed or fall short of benefit payments. When Social Security taxes were last increased in the early 1980s, the economic outlook was for much lower employment and much higher price inflation than actually materialized. Greater economic growth and greater price stability boosted

taxes and curtailed the growth of benefit payments, and these have accounted for a large portion of the current budget surpluses.

This will change when the "baby boom" generation begins to claim its benefits. Each year the Social Security Administration publishes three alternative projections (based on differing projections of employment growth and price inflation). It calls these projections, low cost, intermediate, and high cost. In the latest report, Social Security taxes will fall short of benefit payments sometime between 2009 (the high cost assumption) and 2018 (the low cost assumption). The intermediate assumption now calls for this to happen in 2013. When it does, a portion of benefits will be paid out of general revenues, either from then-current tax receipts or, via borrowing, from subsequent tax receipts.

On the intermediate assumption, the trust fund continues to grow after 2013 because of interest credited to it, but the fund begins to decrease after 2025 and it is exhausted 12 years later. At that point Social Security taxes will only cover 72 percent of benefits, and the proportion will decrease to about two-thirds a few years later. In other words, on the intermediate assumption, if nothing is done to change the program, when 2037 arrives Social Security taxes will suddenly have to become 1.5 times as large as they are now, or benefits will have to be cut by one-third, or that one-third will have to come from general revenues, or some combination thereof.

Because of the booming economy and larger than anticipated immigration, during recent years this date has been receding in the annual reports of the Social Security Administration (not so long ago the trust fund was projected to become exhausted by 2025). For the same reasons, as the anticipated "crunch time" has become more distant the requisite changes have diminished somewhat. This may have caused some politicians to conclude that the problem can be resolved with a little tinkering with the tax rate, the retirement age, the cost of living adjustment, or other benefit calculations.

This could well turn out to be the situation, except for the fact that, from its inception, Social Security been portrayed to voters as a retirement program under which their "contributions" are paid according to earnings, with eventual benefits paid according to lifetime contributions. The implication has been that eventual benefits are somehow "earned." But this is pure fantasy. Congress sets the tax rate and it sets the benefit levels, there is no other link between the two, and Social Security is now and always has been a program of transfer payments, whose principal purpose has been to forestall abject poverty among the elderly.

The benefits paid on the basis of the taxes paid by individual workers and their employers are highly skewed toward those who have had limited earnings. Additional benefits are paid to dependents, to spouses who earned little over their lives (and even to ex-spouses). Everything is indexed—initial benefits to the national average wage and later benefits to the cost of living.

These aspects of the benefit payments may be desirable from the standpoint of a transfer payment program, but they are very expensive. They are paid with current taxes on current workers, most of which taxes are paid by workers with steady jobs at above average wages. Such workers, especially those in two-earner households, now recognize that their eventual retirement checks from Social Security are unlikely to represent a very good return on the taxes paid into the system over the years.

Current workers who have been conditioned to believe that Social Security is a savings and investment plan for retirement are demanding a better deal, one that is more comparable to what is available under private pension plans.

President Bush mentioned using some of what now goes for Social Security taxes for individual investment accounts for workers. The details remain murky. In particular, it would appear that if current workers are to receive a market rate of return on a portion of what they and their employer now pay into the system, there will be a lot less available to pay benefits under the regular program. Taking "a little off the top" to be put in individual accounts would thus necessitate a large reduction in what is to be paid under the regular program to those with such individual accounts. This is because we believe that it is unlikely that Congress will want to reduce benefits paid to current retirees, or to those nearing retirement age, or to skew the payments less toward those with a history of limited earnings and with dependents and ex-spouses. Yet meeting these commitments is what Social Security taxes are used for. To the extent that the balances in individual accounts could be passed on to heirs, the regular program would save less from workers and beneficiaries who die early.

In any event, we believe involving government in the flows of funds to the capital market is a poor idea, and that it would be more useful to strengthen Social Security and its financing by approaching it as the transfer that it is rather than as a retirement plan.

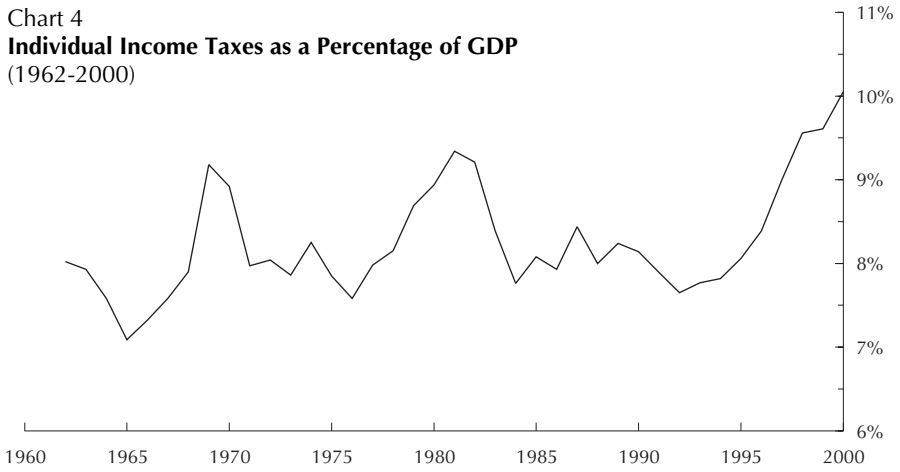
### *Tax Cuts*

Most reports of the President's proposals have focused on the "across the board" income tax reductions that were a centerpiece of his election campaign. Media reports have been filled with the usual sterile discussions of how much an individual or family in a particular circumstance would save.

Those in favor of the cuts tend to focus on the percentage change in tax liabilities, which are greatest for those with low incomes (100% for those who would be removed from the tax rolls entirely). And the critics, as usual, focus on the dollar change, which perforce will be largest for those who now pay the most taxes. The debate seldom rises above different viewpoints regarding who the money belongs to in the first place (one observer's "giveaway" is another's "the government taking less").

What is lacking is any recognition that at higher income levels there is considerable discretion regarding what to report on one's tax return. As the marginal tax rate increases, it becomes more advantageous to postpone income, hide it, or accept a lower rate of return on income taxed at a lower rate. The opposite applies when the marginal tax rate is decreased.

Chart 4
**Individual Income Taxes as a Percentage of GDP**
(1962-2000)



A seldom-discussed question that is much more pertinent than the distribution of the statically calculated dollar tax cuts is the extent, if any, to which a reduction in the highest rate of income taxation to 33 percent (which is apparently the maximum that the President believes to be "fair") would reduce the actual amounts paid by "the rich." Our guess, and it is only that, is that elimination of the 36 percent and 39.6 percent brackets will slightly reduce income tax receipts, but by far less than static analysis indicates.

In any event, Federal income tax receipts have reached an all-time high and, as shown in Chart 4, at 10 percent of GDP they are well above the levels reached before major tax cuts in the 1960s and early 1980s. This suggests a very high probability that Congress will pass a tax cut this year. Indeed the House has passed such a cut already. The House bill is somewhat different from the President's proposals in that it initially makes the largest cuts in the lowest brackets and makes the cuts retroactive to January 1. This was done to counter assertions that fiscal policy takes too long to be implemented to be useful for countercyclical policy purposes, which are based on prior experience. Although the economy has slowed during recent months, there is not as yet sufficient evidence to conclude that a recession is imminent or underway. Even if we are facing recessionary conditions, we believe that the Senate is unlikely to act for several months, by which time such conditions may have abated.

We believe that the President's proposals and the House bill are flawed in that both call for phasing in rate cuts over a period of years. This will have the effect of retarding any "supply side" effect of the cuts, inasmuch as taxpayers will be able to anticipate lower rates "next year" until the cuts are fully phased in. However, we are disappointed in the President's proposals for a much more profound reason.

### *The Road Not Taken*

It is now nearly a quarter of a century since Jimmy Carter pronounced our tax code a "disgrace to the human race." Although the 1986 tax reform act took some steps in the right directions, those changes have since been overwhelmed by new layers of complexity. For a long time we were told that fundamental tax reform was out of the question because of budget stringency.

With the astonishing improvement in the Federal budget outlook, we should be able to take some bold steps to simplify taxes and make them fairer, but that may have a far less certain impact on revenues than manipulating the existing framework. The only initiative of this sort on the table right now is a repeal of the Estate and Gift Tax (see the February 12, *Research Reports*).

Other bold moves could include indexing capital gains (and making the indexed gains taxable at the same rate as other income), or simply giving up on dealing with the "marriage penalty" via endless tinkering with the code to favor single persons or married persons. This issue arises only because all income is "joint property" in some states. The policymakers should get used to it, and allow married couples to file jointly as under present law or as two individuals on the same return using the individual rates. Such optional filing status would eliminate all marriage taxes arising from differences in standard deductions and tax rate thresholds, while leaving marriage bonuses as they are.

The boldest move of all would be to abolish the corporate income tax (the source of much of the mischief relating to campaign contributions and influence peddling in Washington, D.C.) and the payroll tax. Both of these taxes are levied on a portion of added value, and a straightforward tax on all added value could easily replace the revenue. This would best be done as a part of a major overall of Social Security as a sound income support program (this was more completely described in our November 1994, *Economic Education Bulletin*).

Regrettably, such "thinking outside the box" is not how things are done inside the beltway. ❑

## Revival of MSAs

We reported the impending and regrettable demise of the Medical Savings Accounts (MSAs) program in our December 11, 2000 issue of *Research Reports*, "Requiem for a Good Idea." Under Federal tax law at that time, the authority to establish new MSAs was to expire at year-end 2000. The authority for new Medicare+ Choice MSAs, which are available only to persons enrolled in the Medicare program, is provided by a separate statute and is set to expire at year-end 2002.

Unexpectedly but fortunately, about a week after our report on MSAs was published, Congress approved a two-year extension of standard MSAs authority as part of an omnibus tax and budget bill.[1] President Clinton signed the bill during the end-of-year holidays. The Internal Revenue Service (IRS) moved quickly and already has posted revised MSA filing forms (Form 8853) for 2000 returns on the IRS website.

The new, extended MSAs are renamed as Archer MSAs in honor of now-retired Rep. Bill Archer (R.-TX), former chairman of the tax-writing House Ways and Means Committee. With the exception of the new deadline of year-end 2002, the statutes and regulations governing Archer MSAs remain the same as before.

Unfortunately, this means that all the unnecessary restrictions on Archer MSAs described in our previous report on this subject continue, including the limit on offering tax-deductible Archer MSAs to only small businesses (generally, up to 50 employees), the self-employed, and uninsured individuals. Standard MSA plans cannot be offered to large groups on a tax-deductible or pre-tax basis.

The new limits on Archer MSA contributions and deductibles for 2001 are as follows:

| | *Contribution Ranges & Insurance Ranges* | *Upper Limit on Out-of-pocket Expenses* |
|---|---|---|
| Individuals | $1600-$2400 | $3,200 |
| Families | $3200-$4800 | $5,850 |

[1] Community Renewal Tax Relief Act of 2000, Public Law 106-554, Section 202., amending 26 U.S. Code Section 220, which governs MSAs.

**PRICE OF GOLD**

| | *1999* | *2000* | *2001* | |
|---|---|---|---|---|
| | *Mar. 11* | *Mar. 9* | *Mar. 1* | *Mar. 8* |
| Final fixing in London | $294.00 | $290.50 | $266.35 | $263.65 |

***Research Reports*** (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.