106th Congress, 2nd Session: No. 5 February 28, 2000

INFORMED BUDGETEER:

RISKS TO SURPLUS PROJECTIONS

• Ever since CBO released its winter update, many analysts have warned of the various reasons why the projected baseline surpluses will never materialize. In contrast, almost no one has discussed the upside scope for these estimates. In order to even out the debate, we thought it would be useful to review these latter possibilities. The *Bulletin* should stress that it is not predicting higher surpluses, just highlighting possible scenarios.

• For each of the last seven years, federal revenues have grown faster than nominal GDP by two percentage points per year on average. A roughly similar performance is expected in 2000. However from 2001-2010, CBO assumes that revenue growth roughly equals GDP growth (indeed, revenue growth is slightly slower over the next few years). This is a marked change from recent experience and shows that CBO has not fully extrapolated today's good news forward.

• Now many analysts believe that revenues should grow at roughly the same rate as GDP over time, lest taxes take up an ever increasing share of the economy. Of course, this does not apply to each revenue component. The share of individual tax revenues to GDP would be expected to climb due to real bracket creep and the lack of indexation of some thresholds. In contrast, the share of corporate profit and excise taxes relative to GDP edged down from 1960 to 1990. However, on net, these effects are presumed to cancel.

• At first glance, history seems to back up this view. While starting and end points can make a difference, revenues growth has tracked GDP growth fairly closely, with the former outstripping the latter by slightly less than 0.5 percentage points over the last 45 years.

• However, this historical comparison disguises a major factor – whenever revenues rose sharply as a share of GDP, policymakers instituted sweeping tax cuts. The Clinton Administration's opposition to net tax relief means it is unlikely that taxes as a share of GDP will adjust as in the past.

• There are other factors that suggest that revenue growth may be more resilient going forward as well:

< Even if the stock market were to plateau tomorrow, investors will continue to hold large unrealized gains on their portfolio, which they could realize for some years to come. In fact, a stock market decline might increase revenues in the short-term, as investors lock in their gains.

< As the babyboomers near retirement, they will begin cashing out their IRAs and 401Ks, whose returns have accumulated tax-free. These funds will be taxed as regular income upon withdrawal and should be an increasingly important support for revenue collections going forward.

< Technical changes by the Bureau of Labor Statistics have shaved roughly 0.6 percentage points from CPI growth since 1995. These changes have boosted revenues sharply relative to a pre-1995 baseline since tax brackets are indexed with CPI – the slower the rate of bracket adjustment, the more taxes collected. These technical changes are permanent. Indeed, since BLS continues to revise CPI on an ongoing basis, this revenue effect should become more pronounced over time.

• Thus, there are credible arguments why revenue growth may remain robust going forward. If this occurs, the budgetary impact could be enormous. If one assumed that revenues continued to grow two percentage points faster than GDP through the 10-year budget window, revenues would be $3.7 trillion higher than currently estimated.

• The *Bulletin* is not saying that this will happen. A severe stock market plunge and/or economic recession would certainly cause revenue growth to fall below CBO's current projections by a substantial margin. However, at this point, there is no indication of this dire scenario unfolding. Barring this, the current trend suggests more robust revenue growth ahead.

• In a recent paper, Professor Alan Auerbach notes that revisions to official budget forecast are serially correlated – ie, if there was an upward revision to surplus estimates six months ago, there is a better than average chance that the next revision will be to the upside as well. Given the recent spate of upward revisions, this suggests that today's revenue projections could well prove conservative in hindsight.

• Once again, this is not to say that revenues <u>will</u> come in over projection. The *Bulletin* is just highlighting that there are upside prospects to our baseline surplus estimates. The *Bulletin* thought it was important to highlight this fact in light of the copious attention that has been paid to the downside risks.

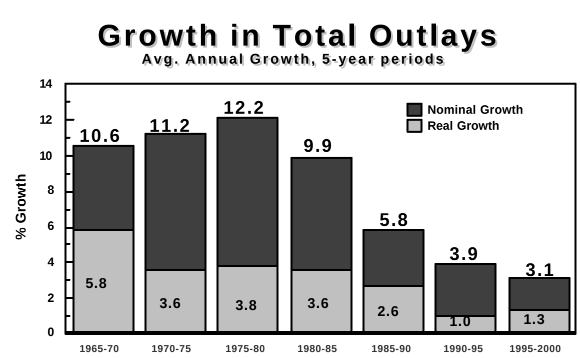
TRENDY GROWTH RATES

• One factor that will definitely effect the size of the surplus in the upcoming years is growth in outlays. There has been much debate on this topic so the *Bulletin* thought it would be helpful to look at the history of growth rates over the past 35 years as we begin the process of producing a Congressional Budget plan. (See chart below.)

• Looking at the average annual rate of growth a dramatic decline in government spending can be seen. The average annual rate of nominal growth soared in the 1970's with 11.2% growth from 1970-1975 and 12.2% growth from 1975-1980. This is a sharp contrast to what we have achieved recently, from 1995- 2000, nominal growth was 3.1%, the lowest since 1965.

• What happens if we take out inflation? The real rate of growth has still been cut by nearly a third over this time period - -from 3.8% in the late 1970's to less than 1.3% today. Despite last minute so-called spending sprees, outlay growth has been kept under control.

• The average growth in real outlays from 1965 to 2000 has been 3.1%. Since 1985- the start of Gramm-Rudman-Hollings law - the real rate of government spending has been well below that average, particularly in the last 10 years.



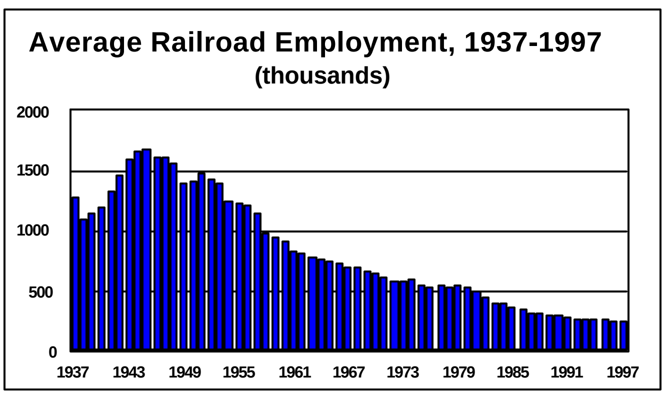
RAILROAD RETIREMENT: A DEPRESSION-ERA ANOMALY

• Since 1935, the federal government has operated and partially financed the retirement system for railroad industry employees. The Railroad Retirement system is wholly unique as the only federally administered pension plan for a private industry. In 1998, there were 784,000 persons receiving retirement or survivor benefits totaling $8.2 billion.

- How did the federal government get involved in the railroad pension business? Railroad companies were pioneers in private pensions, with the unfortunate result that many of the plans were unsound, inconsistent and uncertain with the added pressure of an older workforce due to the railroads' seniority system. After failed attempts to establish union-controlled pensions, railroad labor sought legal and financial protection from Congress. The federal government had a special relationship with the railroad sector, due to its importance in interstate commerce and its dramatic labor-management conflicts in the late 19th century.

- The 1935 Railroad Retirement and Carriers' Taxing Acts established the original system and exempted workers from Social Security taxes and coverage. In the years following its inception, the system followed a pattern of new and expanded benefits as well as liberalization of eligibility requirements, often in an effort to keep up with the growing Social Security program. In the words of the 1972 report of the Commission on Railroad Retirement, "Recurrent and increasingly grave financial problems rose accordingly."

- The demands of World War II only briefly interrupted the long-term decline in railroad employment (see chart below). By the 1970s, the system's financial woes had become apparent, as well as the difficulties caused by lack of coordination with Social Security. Although Congress had set up a "financial interchange" between the two programs to adjust for benefit and revenue effects, many workers received high "windfall" benefits by working in and out of the railroad sector long enough to qualify for payments under both programs.



- In legislation passed in 1974, 1981, 1983, and 1987, Congress reformed Railroad Retirement to make it more like private pensions in other industries (although it is still run by the federal government) and to bring it back from insolvency. Congress divided the program into three basic parts:

  1. There is a Social Security equivalent component that is financed by payroll taxes identical to FICA taxes for Social Security. This part of the program is coordinated with the Social Security Administration and is effectively financed from the Social Security trust funds.

  2. There is an industry financed defined-benefit pension component that is on top of the Social Security component. It is supposed to be financed entirely by the industry and worker contributions, although taxpayers have inadvertently subsidized this fund over the years. For instance, in 2000, the general fund will transfer $265 million to this fund. No other private industry pension gets this kind of subsidy.

  3. There is a windfall benefit, financed by federal taxpayers, and paid to railroad workers who got extra benefits due to uncoordinated coverage between Social Security and Railroad Retirement before 1974.

- Despite these reforms, high payroll taxes on workers and railroads, and the generous subsidies, the rail industry pension fund is still underfinanced by any measure due to the severe imbalance between workers and retirees. Currently, there is only 1 worker for every 3 beneficiaries.

- Using the standard established by ERISA for industry pension funds, the railroad industry pension plan has an unfunded liability of $38 billion.

- One of the reasons the pension fund is underfinanced is that it gets a low return on its reserves because those reserves are held in a government trust fund invested in special issue Treasury securities.

- By one analysis, if the rail industry pension fund had been in the private sector, invested like other multi-employer plans since 1985, it would have $16.6 billion more in reserves than it does today.

BUDGET QUIZ:

WHAT IS THE REAL RISK TO THE SURPLUS?

- The Senate Budget Committee held a hearing with CBO Director Crippen on January 26, 2000. After that hearing, Senator Domenici submitted several questions for the Director to answer for the record. The Committee has received Dr. Crippen's responses and the *Bulletin* would like to bring your attention to the following:

  Question: How much did last year's legislative action reduce the 10-year projected surpluses?

  Answer: CBO estimates that legislative action since July 1999 reduced projected surpluses by $127 billion over the 2000-2009 period.

  Bonus Question: How much of the reduced surpluses were the result of higher spending?

  Answer: Higher spending from legislative changes account for about 86 percent ($106 billion) of the reduction in surpluses.

- The conclusion the *Bulletin* draws from these answers is that the real risk to the surplus is spending!

CALENDAR

February 29: Senate Budget Committee Hearing: The Fiscal Year 2001 Budget: Nuclear Nonproliferation, Stockpile Stewardship and Other Energy Programs. Witness: Secretary of Energy, Bill Richardson. The hearing will be held in Dirksen 608, at 10:00 am.