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Budget—The Big Picture

Henry J. Aaron

Every American under the age of 30 will be treated to a new experience later this year—the announcement that the federal budget had ended the fiscal year with a surplus. If current policies are maintained and if demand remains strong, surpluses will continue into the second decade of the next century. No seraphic chorus will accompany the first budget surplus since 1969, but the event will herald a rare economic opportunity. The political significance of this budget is that Republicans and Democrats cooperated to solve an important problem. To be sure, ill-conceived policies—tax cuts not matched by expenditure reductions—created the deficit. The fact that the system worked is worth celebrating.

The economic significance of balancing the budget is also straightforward. The federal budget influences national saving, which is the difference between private saving and public borrowing. Deficits lower saving. Surpluses raise it. National saving determines how much investment U.S. residents can support. More investment means economic growth and higher future living standards.

"National saving determines how much investment U.S. residents can support."

The United States has not been saving much lately. Net saving has fallen from an average of 11.4 percent of net domestic product (1950–1979) to 5.3 percent (between 1985 and 1995). Declines in household and business saving and increased government deficits both contributed to this drop. In recent years, private saving has remained low, but the federal budget deficit has fallen, from 4.3 percent of domestic product (1985–1995) to now close to 0 percent, and is projected to move into surpluses that could exceed 1 percent within the next decade. This swing means higher national saving, which will contribute to increased economic growth. Compound interest works inexorably: saving an additional 1 percent of domestic product raises the growth of the nation's income by about 0.1 percent each year. Saving 5 percent more every year between now and 2010 would boost output about 6 percent—more than $600 billion in 1998 dollars.

Such gains would be timely, because future U.S. workers face the challenge of paying for health and pension benefits for the baby-boom generation that will start to retire around 2010. Over the succeeding 30 years, the cost of Medicare and Social Security will rise by about 6 percent of domestic product, a sizable but manageable burden. But rapid economic growth will enable workers to enjoy rising living standards and simultaneously to boost government revenues.

Even if prosperity is uninterrupted, preserving the budget surpluses and realizing higher national growth are far from certain. Elected officials may succumb to the urge to cut taxes, which would raise private consumption, or to increase public spending, which would push up public consumption. Both would hold down saving and the potential for increased economic growth. One should fear an unholy alliance between members of Congress who are anxious to shrink government, and who seem never to have met a tax cut they did not like, and others who have a list of "high priority" expenditures they want to promote.

Each of us could doubtless list public expenditures that we believe would do a lot of good. My first choice would be more health care for the uninsured. For many of us, additional support for basic and applied research would rank high, and scientists should help make the case that such outlays would advance knowledge and promote economic growth. But the political reality is that each advocacy group—and that is how Congress views scientists—can win a majority of votes only by letting others add items from their menus...such as more money for roads, or national defense, or tax cuts. The need to form coalitions and accept compromise creates the risk that we will end up with a mélange of expenditure increases and tax cuts seriously diluted with low-priority items. In that event, we will have lost a rare opportunity to use budget surpluses to raise capital formation, improve living standards, and prepare for the costs of care for the aging baby-boomers.

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