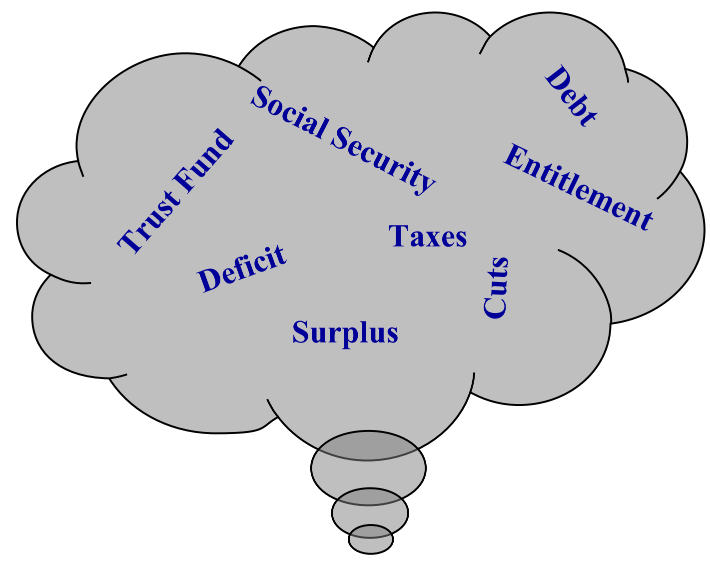
The U.S. Federal Budget

A tutorial to clear the fog……..



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Budget Terms

We start our discussion by getting a fix on some critical terms.

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Federal Budget

- *Budget* refers to a particular year's incomes and outflows to the federal government.
  - Same as *income statement* or *profit-and-loss* statement for a person or firm.
  - Is associated with a particular "fiscal year".
  - Government fiscal years run from Oct 1 to Sept 30
- The Budget *Balance* refers to whether income exceeds outflow or vice-versa.

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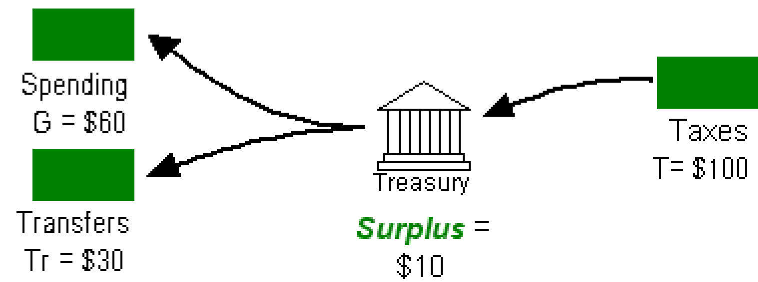
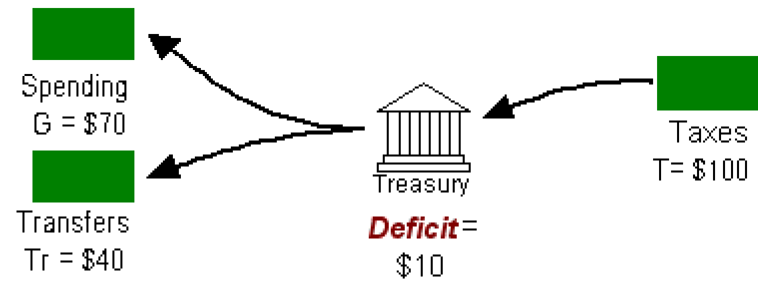
The Budget Balance: Deficit vs. Surplus

- Budget Balance =
  - Income – Outflow
  - Taxes minus GovtSpending minus Transfers
  - T – G – Tr
- If Balance is:
  - positive → *surplus*
  - negative → *deficit*
- The terms *deficit* and *surplus:*
  - Refer to flow variables
  - Summarize the budget balance each fiscal year.
- Deficits are paid by ***new borrowing***





Govt Treasury

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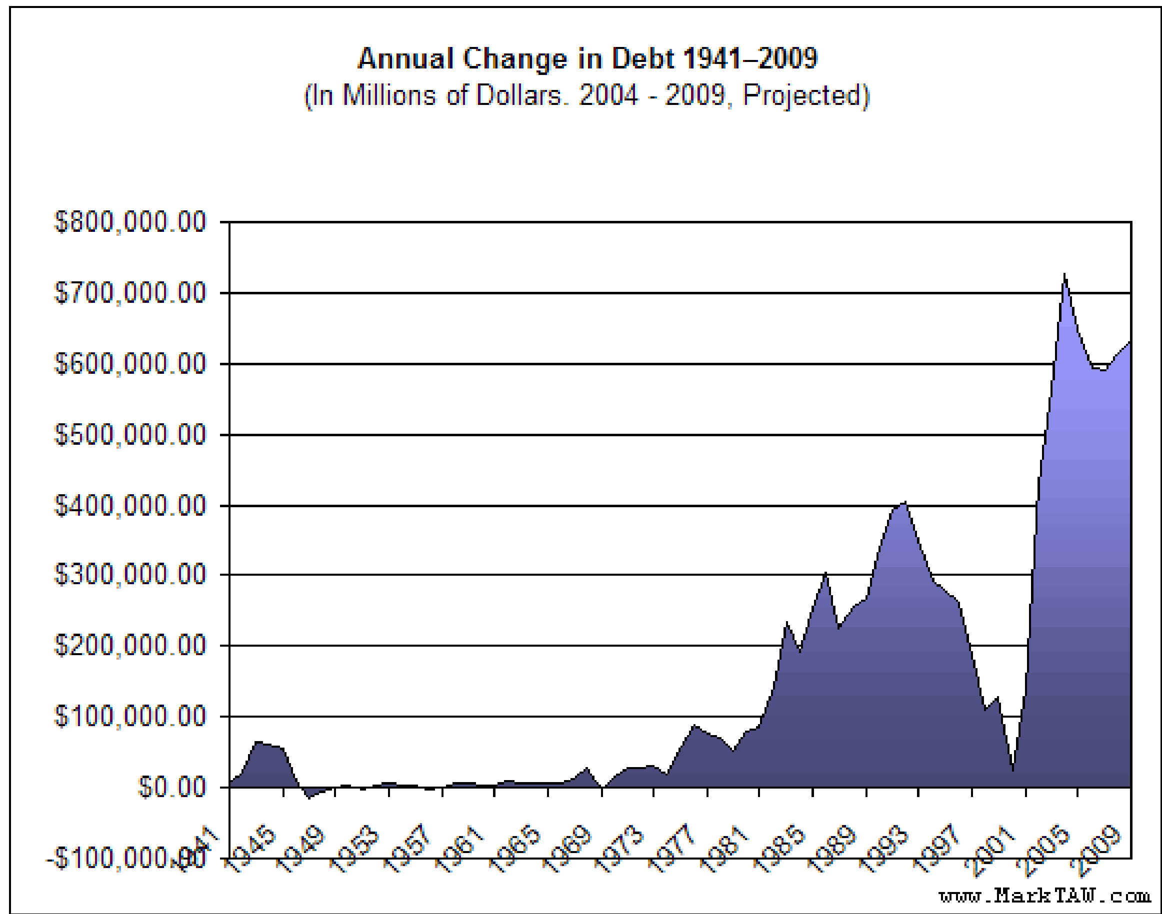
Deficits & Surpluses Change Debt

- Deficits are shortfalls in money – government must borrow to cover shortfall.
  - ***Deficits add to Total Debt***
- Surpluses are excess money – government uses the excess to pay-off old debt
  - ***Surpluses reduce Total Debt***

Graph shows each year's increase in Debt since 1941. This is the <u>true deficit</u> for each year. However, sometimes the government "disguises" these true deficits and reports smaller numbers or even surpluses – more on how they do that later in this tutorial.



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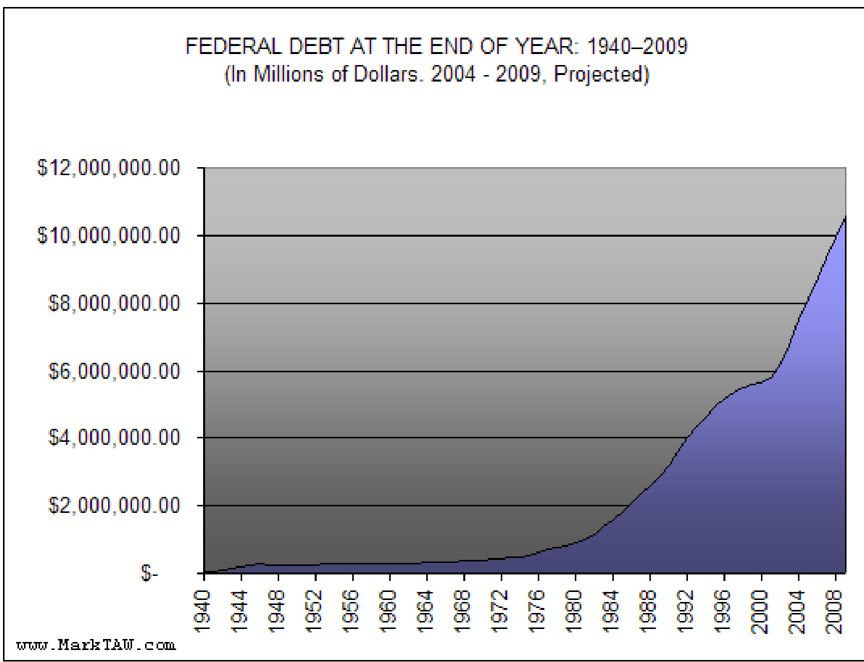
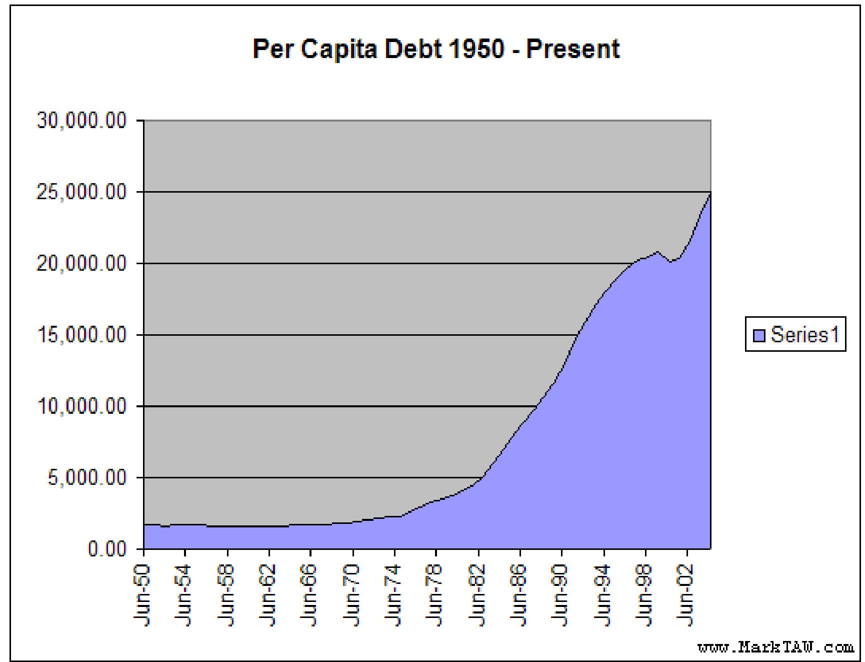
Deficits and Policy: The Historical Record

- Virtually all governments run large deficits in war-time.
- In peace, Keynesian policy recommends counter-cyclical policy:
  - Deficits during recessions to stimulate economy
  - Surpluses during expansions to pay down debt created during previous recession.
- At the time this is written (Sept 2007), Total U.S. National Debt = approx $ 9 trillion, or just a little less than $30,000 for each person in the U.S.





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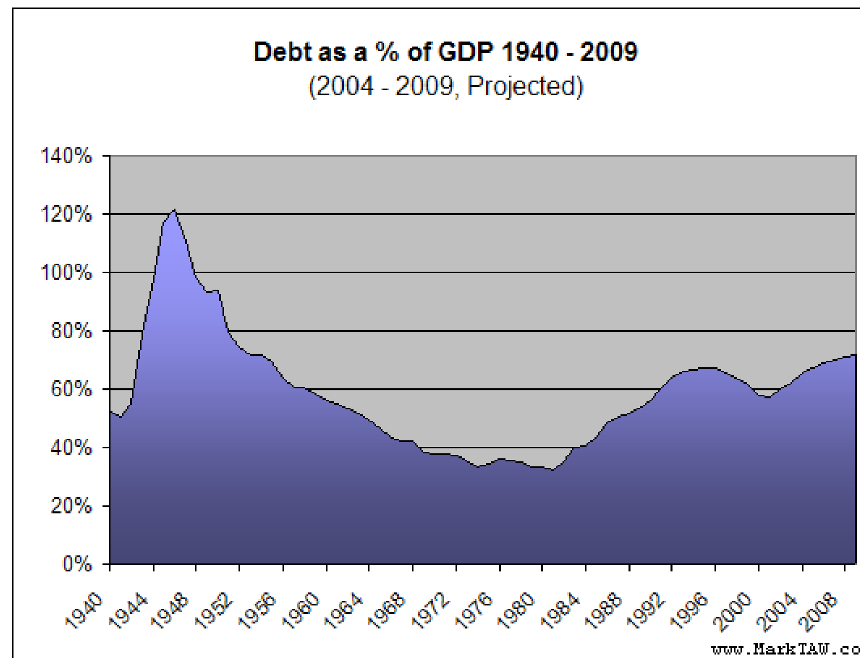
Rising Debt, but A Rising Income & Economy, Too

- Economists differ about how to measure the "burden" of the debt. The most common way to assess the "burden" of the debt is to compare the debt to GDP. GDP represents a nation's total income (production) each year.
  - This is like when a bank compares your current income to your total personal debt to see if you are good "credit risk" and whether you can make the interest payments on the debt.
- *The U.S. national debt-as-%-of-GDP reached a peak in World War II (large debt – small GDP). As GDP grew in 50's-70's, debt-to-GDP declined. In the 1980's federal deficits have grown and debt-to-GDP grew. GDP growth in Clinton years helped reduce the ratio. In recent years, the war spending combined with weak GDP growth has seen ratio climb again.*



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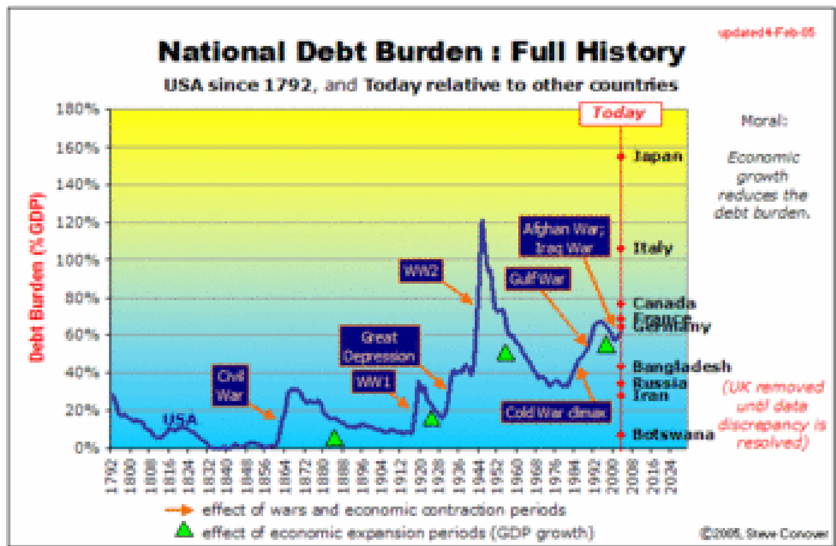
How Much Debt is Too Much?

- Debt is too much when:
  - Creditors (those lending the government the money) refuse to lend new money or to roll-over old bonds when they become due. Why? Because creditors (lenders) may:
    - Lose confidence that the government will make interest and principal payments and refuse to buy new bonds.
    - Decide they no longer want to own assets (the bonds) in that currency (most likely to happen with foreign creditors)
  - Interest payments become so large that they take over the government budget, forcing cuts in human services or defense.
    - When a national government cannot make interest payments on its debt, it "defaults". Unlike a personal or business default, a creditor in a government default cannot "repossess collateral property" or "force bankruptcy". The creditor either walks away from the debt, renegotiates the amount of the debt, and/or promises to never loan to that government again.



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When Is A Reported ***Surplus*** Actually a ***Deficit***?

Answer: When the government plays accounting tricks using *trust funds*.

To understand, we need to first examine how a government trust fund program operates. We will use the largest trust fund program, Social Security, as an example.

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What Is The *Social Security* Program?

- Social Security (SS) is a program started in The Great Depression to help protect workers who lived "too long". It was intended to provide a supplemental income (not a full pension) to people who could not work due to age or disability.
- SS is called an Intergenerational transfer program. Most developed, industrialized nations have some form of similar intergenerational transfer program.

- For more information about the history and workings of Social Security see:
  - ***Social Security Administration Web Site***
  - ***Rational Revolution Web Site***
  - ***Just Facts Web Site***

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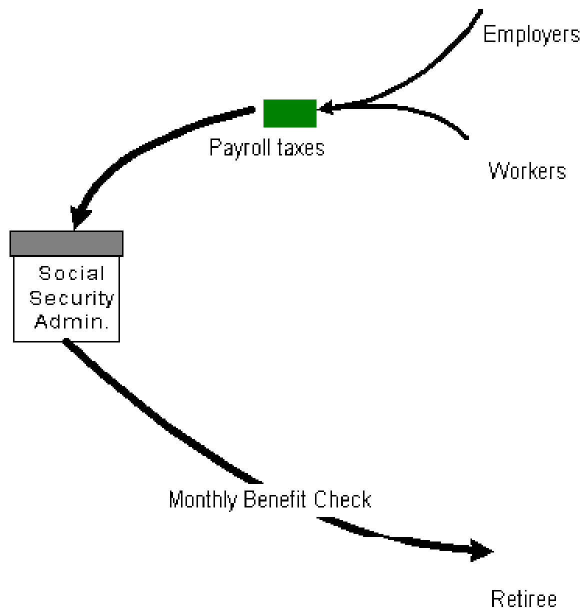
How Does *Social Security* Work?

SS is called an Intergenerational transfer program: current workers pay taxes this year which are then paid that same year as benefits to retirees & the disabled. When the current workers eventually get old enough and retire, the next generation works & pays taxes to support their benefits.

- *SS is NOT a savings or retirement investment program. It is NOT like a 401(k) or an IRA.*
- *A current retiree's benefits are provided by the taxes paid by current workers.*

Amount of benefits that can be paid to each retiree depends upon:

- Ratio of # of workers per retiree in the economy
- Size of payroll (how much workers earn)
- Tax rate on payroll



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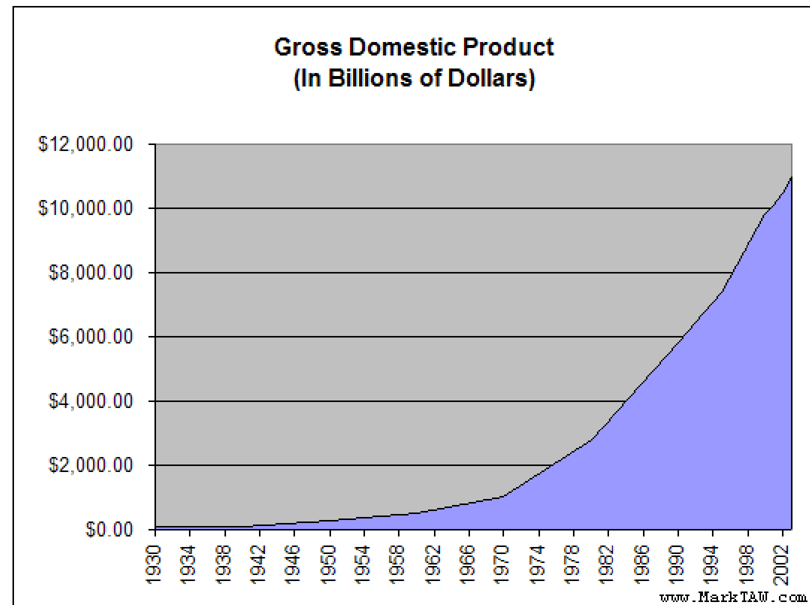
Key Changes Strengthening SS Finances

Social Security Benefits Have Risen & Continue To Rise

Positive changes helping to finance increased benefits:

- US economy (GDP & payrolls) have grown (see graph)
- Baby boomers & women entering workforce in 60's-70's → *more workers*
- Retirement age being raised to 67
- Social Security tax rates rose until mid-1980's

  1950: 3.0% (combined employee share + employer share; not counting Medicare tax)
  1960: 6.0%
  1970: 8.4%
  1980: 10.2%
  1990: 12.4%
  2000: 12.4%
  Today: 12.4%



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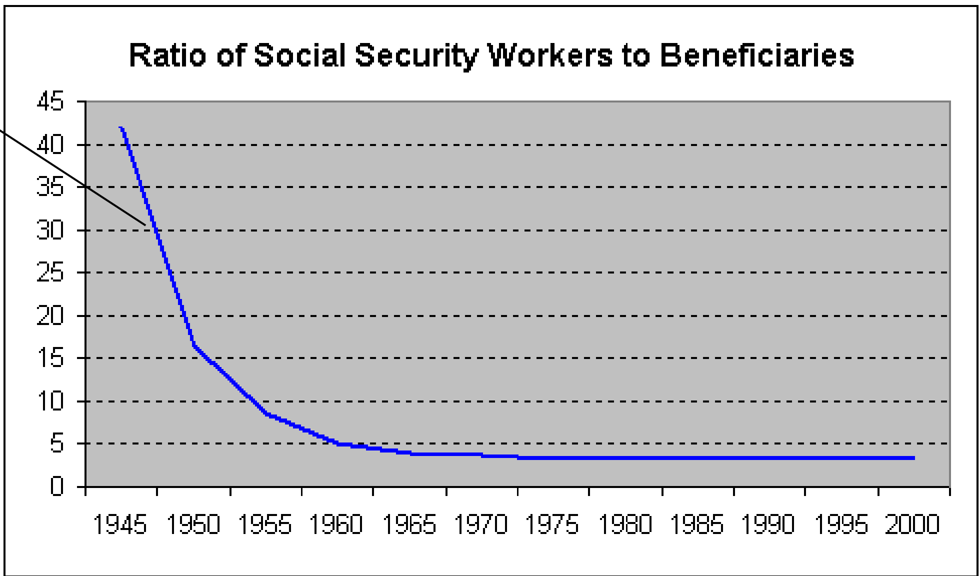
Changes Weakening SS Finances

- Life expectancy has risen (retirees live longer & collect benefits longer)
  Life expectancy in 1936: 65 years; today: 78 years
- ***Future:*** Baby boomers expected to start retiring beginning in 2010
  - Will reduce the workers-to-retirees ratio
  - Ratio expected to drop to 2.1 workers per retiree by 2030

Planning for expected drop in future ratio caused govt to begin building up the Social Security Trust Fund

The reason ratio was so high before 1960 is because the program started in 1936 and to be eligible for benefits a person had to pay into the system. It took 20+ yrs for people who paid in to retire & draw benefits.

The system has functioned with 3.0 to 3.5 workers per retiree for over 30 years.



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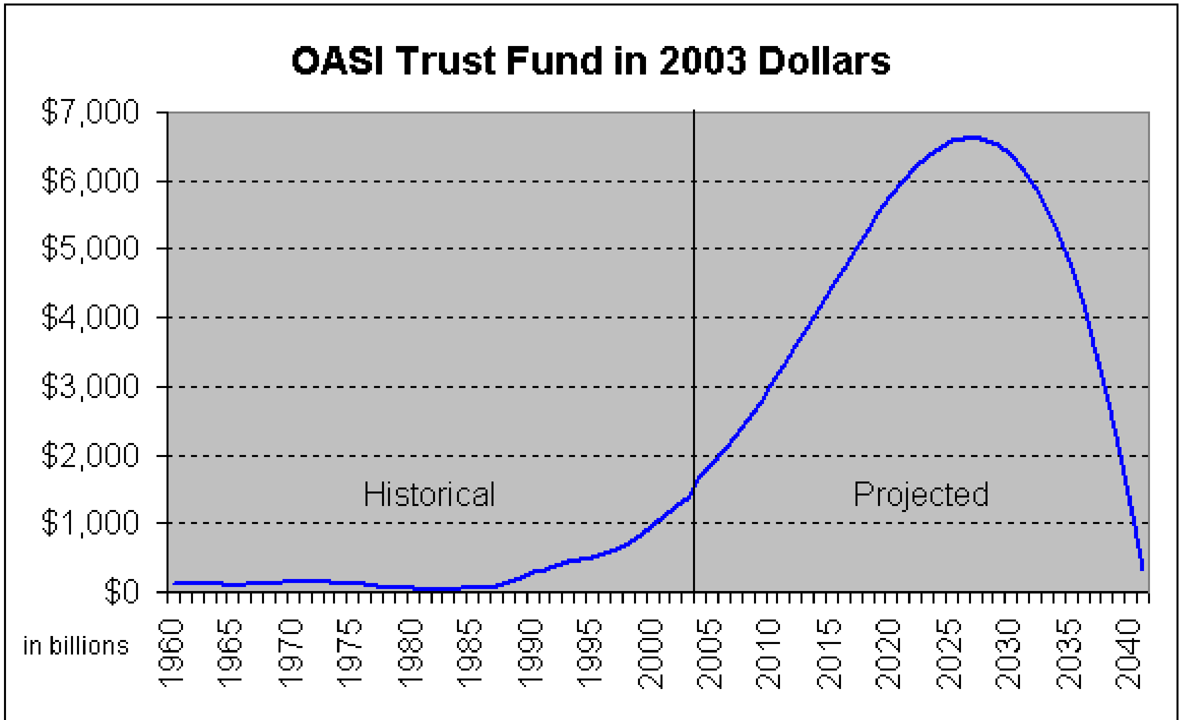
What Is the Social Security Trust Fund?

In a particular year, if Payroll taxes collected exceed the benefits paid, then the ***surplus*** is kept in a fund called the Social Security Trust Fund. The purpose of the trust fund is to provide a source of money for any future years in which payroll taxes might be less than benefits paid-it's a fund to pay for *future Social Security deficits*, not to pay for current deficits in the rest of the government. But that is how it has been used.

Trust Fund began to build during 1990's anticipating future baby boomer retirements

By law, the Social Security Administration is required to "invest" the Social Security Trust Fund in U.S. Government bonds.



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What Is the So-Called "Social Security Crisis"?

Some politicians and analysts foresee a "social security crisis" in the sense that, given current projections, the Social Security system will:

- Continue to run surpluses (add to trust fund) until somewhere between 2018 and 2028
- Then, somewhere between the years 2018 and 2028 the number of retirees will grow and SS will run deficits (benefits paid will exceed taxes collected), which will draw down the trust fund.
- The deficits will continue until approx 2043, when the trust fund runs out.
- After 2043, total benefits will be limited to total taxes collected, possibly requiring a modest cut in benefit levels from today's planned benefit levels.

Note: All Social Security projections, especially as far out as 2050 (over 40 years from now) are extremely sensitive to assumptions made about:

- Population growth, including immigration (1/3 of workers in the year 2050 haven't been born yet!)
- GDP Growth rates
- Changes in life expectancy (how long the elderly will live)
- Labor force participation rates
- Age at which people will actually retire
- Whether or not people work after retirement

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Will Social Security 'Be There' When You Retire?

YES, assuming that Congress does not totally end the program or privatize it.

- Depending on your age and in what year you retire, your Social Security benefits might be 10-30% than currently planned benefit levels. But current planned benefit levels for the future are much higher than today's benefits.
- It is reasonable to assume that future benefit levels, even if you retire in 2050, will be at least as great as today's benefits.

The ***real*** Social Security "crisis" is actually a federal government budget & debt crisis…….

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Back to:
"*When Is A Reported Surplus Actually a Deficit?*"

The ***real*** Social Security crisis is actually a federal government debt and budget crisis.

Since the mid-1980's, the Social Security Trust Fund has been accumulating due to surpluses in Social Security (taxes > benefits paid).

These Social Security surpluses (the trust fund) have been used to help fund other government spending and reduce the amount of other government borrowing.

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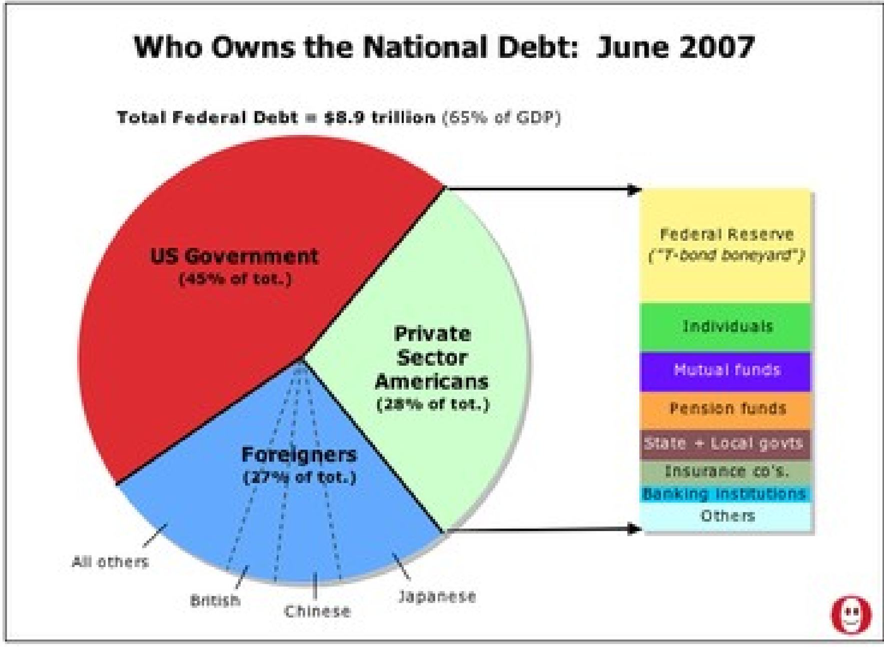
To Whom Is The National Debt Owed?

- Because Trust Fund programs are required to "invest" the trust funds in U.S. Government bonds, much of the debt issued by the U.S. Government is owned by other agencies of the federal government.
  - Trust funds: Social Security, Medicare, Medicaid, Highways (gas taxes), Government employees pension funds, FHA, Airports, FDIC, etc.

- In June 2007, U.S. Government total debt = $ 8.9 trillion, of that..
  - $ 3.9 trillion (45%) was owed to government trust funds
  - $ 5.0 trillion (55%) was owed to the "Public", meaning the bonds were being held by non-government individuals and organizations, approximately half of which are foreign entities.
    - Of the portion owned by foreigners, 64% is owned by foreign central banks.



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So,
When Is A Reported Surplus Actually a Deficit?

The Government (and politicians) add the Social Security (and other trust fund) surpluses into the Federal Budget numbers when reporting a "deficit" or "surplus".

Thus, as long as the government's deficit in a particular year can be financed by selling bonds to the Social Security Trust Fund, the government will report a "surplus", even though total national debt has increased.

This is how the Clinton administration reported budget "surpluses" in 1998-2000. In fact, the non-Social Security portion of the government was running a large deficit, but Social Security ran enough of a surplus that the government did not need to increase borrowing from the public.

The U.S. government has not run a true surplus for over 50 years.

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Why Is Government Spending So Difficult to Cut?

To understand, we need to see where the money goes.

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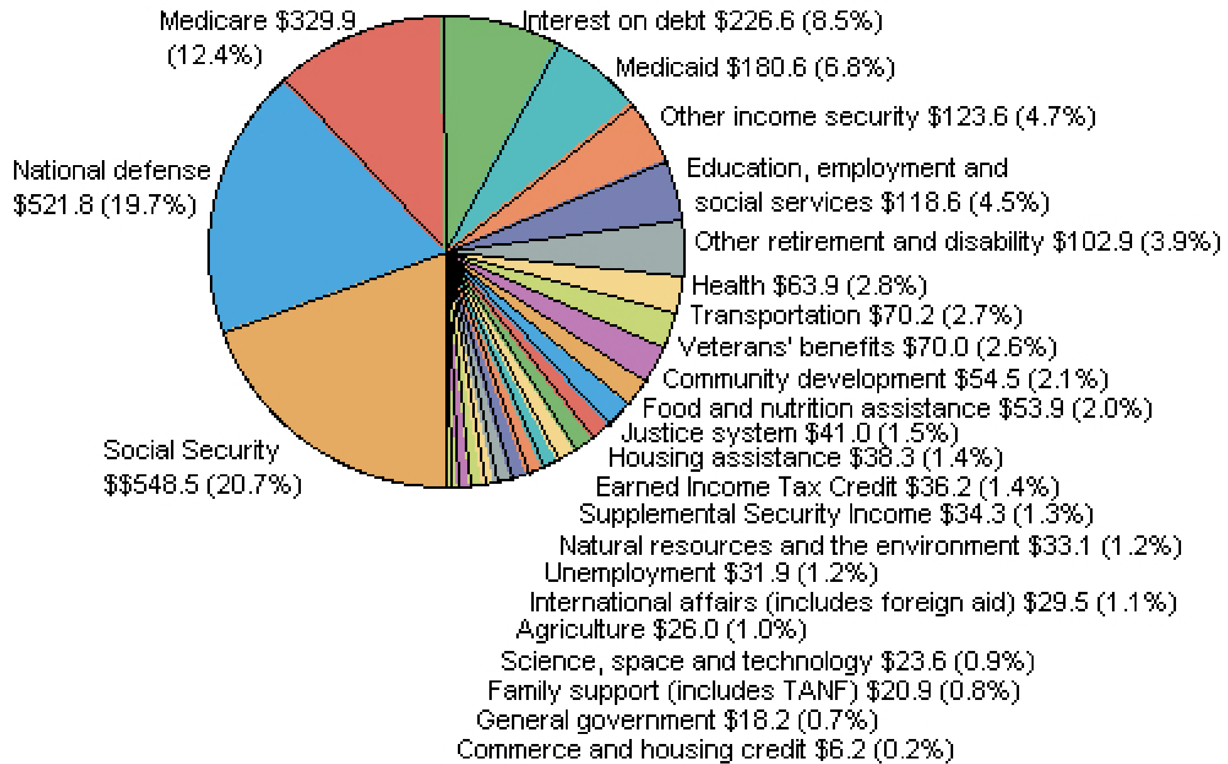
Where Does the Money Go?

- Approx. 2/3 of all government spending each year is already committed by decisions of previous Congresses in the form of:
  - Entitlements: Promises to social program beneficiaries (Social Security, Medicare, Veterans) – cutting these means breakings "solemn promises" to citizens
  - Interest on Debt: Contractual promises to pay interest to bondholders – not paying means default

- Of the balance, the overwhelming majority is for national defense and homeland security. Since 9/11, these have been politically difficult to cut. In fact, increases in defense and homeland security spending have caused the budget to change from near-surplus in 2000 to record deficits.



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In Government-talk, a "Cut" Could Mean an Increase

- Each year's budget contains both:
  - A set of spending numbers by agency for the current fiscal year, and
  - Projected spending spending for each agency for *future* years out until 10 years in the future.
- In government-talk, a spending "cut" is when the current budget amount is less than was projected for this year when last year's budget was submitted.
  - A "cut" is does NOT necessarily mean this year's budget amount is less than last year's budget amount.
- So, government agencies can have their budgets "cut" each year, but still have more money to spend each year than the previous.

Example: Let's look at a hypothetical budget for some program that we'll call XYZ.

The Fiscal Year 2004 budget numbers calls for:

Spending $100 in 2004 and projected spending of $110 in 2005, a 10% increase for 2005 over 2004. Govt actually spends $100 in 2004.

The following year the Fiscal Year 2005 budget calls for:

Spending $106 in 2005. This will be called "cutting" the budget for XYZ, even though $106 is still greater than the $100 spent the year before. However, the increase in spending was cut. Instead of increasing spending by $10, the spending was only increased by $6.

This is will be called a "Spending Cut" by most politicians of both major parties.

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