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Abolish the Surplus
Policy Note 1999/01

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The worst thing about the Federal Government's surplus may be the incessant squabbling it has generated about "what to do with the budget surplus" -- with some preferring "tax cuts", others advocating "spending enhancements", and still others recommending that we "save the surplus". Unfortunately, almost all of those caught up in this debate display little understanding of the nature of a budget surplus, and still less comprehension of the impact that a surplus has on the economy. Thus, I propose that we simply *abolish* the use of the term "surplus" when speaking of a situation in which the government takes in more tax revenue than it spends. Let us call it the "government's net drain on private sector income", or, better still, the "great sucking sound as private wealth is destroyed by government".

In a recent **Dismal.com** piece, Irwin Kellner rightly questioned Washington's projections of $3 trillion worth of budget surpluses over the next 15 years. Such projections are based on wishful thinking, creative accounting, and preposterous forecasts of government revenue and expenditures. The tenuous nature of these projections is not merely due to the inherent difficulty of making such projections, nor is it due to a supposed proclivity of Washington to spend down its "savings". Rather, it is because continued economic growth in the presence of a budget surplus and a trade deficit requires that the gap between private income and private expenditure continue to increase beyond its already unprecedented scale. As my colleague, Wynne Godley, and I have argued in a recent piece ("Can Goldilocks Survive?") the only thing that has sustained the current US expansion is the willingness of the private sector to spend more than its income -- something that simply cannot continue indefinitely.

At the macroeconomic level, government expenditures generate private sector income, while taxes reduce disposable income. When government spending exceeds tax revenue (incurring a budget deficit), there is a net addition to private sector disposable income. This may well have secondary and tertiary effects (for example, greater disposable income may induce household spending on goods produced domestically or abroad, thereby raising consumption or imports). In any case, a budget deficit necessarily increases private sector nominal wealth held first as non-interest-earning cash and bank reserves for the simple reason that the total value of checks issued by the Treasury to finance expenditures would exceed the total value of checks written by the private sector to pay taxes. The Treasury then normally sells bonds to offer an interest-earning alternative to cash and bank reserves. In other words, government deficits always add disposable income to the private sector which is received first as a Treasury check and which then may be transformed into an interest-earning government debt.

On the other hand, budget surpluses require that tax revenues exceed government spending. In this case, private sector disposable income is reduced by the amount of the surplus. Again, there may be further effects (consumers may slash spending, for example). Because checks received by the Treasury exceed the value of checks issued by the Treasury whenever there is a surplus, outstanding cash and bank reserves will be reduced. To restore cash and reserves, the private sector sells Treasury bonds. The end result is that the private sector's wealth declines by the amount of the surplus--with the reduction mainly taking the form of Treasury debt retirement. Thus, running a $3 trillion surplus over the next 15 years would mean that private sector nominal wealth must be reduced by an equivalent $3 trillion.

Can our economy withstand such bloodletting? Our own history suggests this is highly improbable -- the US has experienced exactly six depressions in its history and every one of these followed close on the heels of federal government surpluses that destroyed private sector wealth. For a more recent example, we can look to the experience of Japan -- whose recession-cum-depression began with government budget surpluses at the end of the 1980s.

Those who believe that a surplus can be "saved" for the future, or "used" to finance tax cuts or spending increases simply do not understand the nature of a surplus. Does anyone really believe that we can "save for the future" by burning $3 trillion worth of private sector wealth? During any period, the government can always choose to spend more (or less), in which case the surplus over the period may be lower (or higher); similarly, it can increase (decrease) taxes and thereby may increase (decrease) the surplus. But, as Gertrude Stein said, "there is no there there" -- a surplus exists only as a deduction from private sector income. The negative household saving that some commentators are finally noticing is merely the accountant’s flip-side to the budget surplus. A government surplus necessarily reduces private sector savings and cannot be "saved for the future".

It is very difficult to take seriously any analyses that begin with the projection that our government will run surpluses for the next 15 years. Part of our skepticism comes from the inherent difficulty in making projections. More importantly, it is difficult to believe that our economy can continue to grow robustly as the government sucks disposable income and wealth from the private sector by running surpluses. When the economy slows, the surplus will disappear--automatically and because the private sector will eventually demand that the government stop draining income from the economy. Tax cuts will be rushed through Congress and the president will put forward spending initiatives. When the government decides to spend more or tax less, that will banish the surplus and result in more private sector income and wealth. At that point, all this silly talk of "saving the surplus" will join the Laffer Curve, Rational Expectations, and Ricardian Equivalents in the dustbin of discredited intellectual missteps. ◆

FOR FURTHER READING

(Available from http://www.levy.org/publications/publications.html)

"Surplus Mania: A Reality Check," Jerome Levy Economics Policy Note 1999/3, L. Randall Wray

"Can Goldilocks Survive?" Jerome Levy Economics Policy Note 1999/4, Wynne Godley and L. Randall Wray

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