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A Primer on Government Surpluses  
Special Report 2000/02

**L. Randall Wray**  
Research Director, CFEPS

**Bard**

**CFEPS**

*Center for Full Employment and Price Stability*

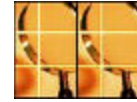
# Special Report 00/02



## **A PRIMER ON GOVERNMENT SURPLUSES**

BY  
L. RANDALL WRAY

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# A PRIMER ON GOVERNMENT SURPLUSES

BY L. RANDALL WRAY, SENIOR RESEARCH ASSOCIATE

## **What is a federal government surplus?**

When the federal government's revenue exceeds its spending over the course of a year, it is running a budget surplus and outstanding Treasury securities will be reduced by the same amount over the year. In 1999, the federal government's surplus was \$99 billion and it is projected to grow to \$142 billion for fiscal year 2000. This means that US taxpayers will pay \$142 billion more in taxes this year than the government spends. More concretely, taxpayers will write checks to the Internal Revenue Service in the amount of \$1.914 trillion, while the US Treasury will write checks received by Americans in the amount of only \$1.772 trillion—a difference of \$142 billion. The only way that taxpayers can write checks to the IRS that exceed the amount of checks received from the Treasury is to surrender \$142 billion of Treasury securities to the government. In other words, running a surplus necessarily means that the Treasury is reducing nominal wealth of the non-government sector. This is why federal budget surpluses reduce outstanding Treasury debt and non-government sector net nominal worth.

## **What is the long-term effect of running perpetual government surpluses?**

On current projections, the federal government will run surpluses over this decade that will total more than \$2.9 trillion, leading to an equivalent reduction of non-government sector net nominal wealth—of \$2.9 trillion. This wipes out almost 80% all of the publicly-held US Treasury debt, including that now held by foreigners. No one can accurately predict how the economy will react to such an unprecedented reduction of its nominal wealth—especially when the most liquid assets will be removed from private portfolios. However, throughout our history, the US has experienced exactly six periods of substantial reduction of federal government debt, achieved through persistent budget surpluses, and each of those periods ended in one of our nation's six depressions. Our last period of substantial surpluses occurred between 1920 and 1930, when Treasury debt was reduced by 36%; the Great Depression began in 1929. For a more recent example, Japan began to run government surpluses in 1987, which reduced non-governmental nominal wealth and generated a deep recession that has already lasted a decade. Note, however, that neither the US in the 1920s nor Japan in the late 1980s came close to draining \$2.9 trillion worth of wealth from the economy, even after adjusting for higher prices today.

## **Doesn't a budget surplus allow us to save for the future?**

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".

## How do budget surpluses impact non-government sector financial balances?

There is another, less transparent, impact of government surpluses on the non-government sector. At the level of the economy as a whole, when one sector spends more than its income, another necessarily spends less for the simple reason that in the aggregate, total spending equals total income. Let us, then, disaggregate the economy into three sectors to determine the implications of government surpluses for the other sectors. First, we can consolidate all levels of government into a public (or, government) sector, and likewise consolidate households and firms into a domestic, non-government (or, private) sector. For completion, we must add a foreign (“rest-of-the-world”) sector. At the aggregate level, the spending of all three sectors combined must equal the income received by the three sectors. It is clear that if the public sector is spending less than its income—that is, it is running a surplus—this must imply that at least one other sector is spending more than its income (in other words, is running a deficit). Mathematically, the sum of the balances of the three sectors must equal zero. It is convenient for our purposes to write this as:

$$\{\text{Public Sector Surplus}\} + \{\text{Foreign Sector Surplus}\} = \{\text{Private Sector Deficit}\},$$

which merely moves the private sector balance to the right-hand-side and reverses the sign (in other words, writes the balance as a deficit rather than a surplus, since a negative surplus is the same thing as a deficit).

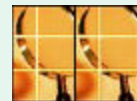
Because the US has been running a balance of payments deficit in recent years, this means that the foreign sector is in surplus (the rest-of-the-world receives more US dollars than it spends). A few years ago, our public sector ran a sufficiently large deficit to more than offset the foreign sector surplus, so that our domestic non-government sector was able to run surpluses. However, in the past two years, the US public sector’s balance has turned toward surplus. When combined with our balance of payments deficit (or foreign sector surplus), this means that the domestic private sector’s balance (that is, its savings) has turned sharply negative—toward large and growing deficits. The non-government sector deficit is now approximately equal to 5.5 percent of GDP—far and away the largest private sector deficit the US has seen in the post-war period.

## Will the federal government really run surpluses for the next decade?

It is very difficult to take seriously any analyses that begin with the projection that our government will run surpluses for the next decade. 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 eventually disappear—automatically—as unemployment compensation rises and tax revenue falls due to the slowdown. As the government spends more and taxes less, the surplus will vanish.

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The Center for Full Employment and Price Stability is a non-partisan, non-profit policy institute at the University of Missouri - Kansas City dedicated to promoting research on and public discussion of issues related to macroeconomic and monetary policy, especially employment and budgetary policy. The Center is interested in your feedback on the ideas put forward in its publications. You can contact us at:

**Center for Full Employment and Price Stability**  
University of Missouri – Kansas City  
Department of Economics; 211 HH  
5100 Rockhill Road  
Kansas City, Missouri 64110

tel.: 816-235-5835  
fax: 816-235-6558  
[www.cfeps.org](http://www.cfeps.org)  
[cfeps@umkc.edu](mailto:cfeps@umkc.edu)