107th Congress, 1st Session: No. 8 March 19, 2001

Informed Budgeteer

A FAULTY PLAN

- Some have argued that trimming back the President's proposed $1.6 trillion tax cut over 10 years and setting aside 1/3 of the on-budget surplus would help us "save" Social Security and Medicare. The *Bulletin* would like to take this opportunity to explain why reform is the only way to actually save these entitlement programs.

- CBO estimates that over the next 10 years, payments into the Social Security Trust Fund will exceed outlays by $2.5 trillion. Similarly, payments into Part A of the Medicare Trust Fund will exceed outlays by $0.4 trillion. Saving one-third of the remaining $2.7 trillion in surpluses amounts to an additional $0.9 trillion. Surely dedicating all this money, an astounding $3.8 trillion in Social Security surpluses, Medicare HI surpluses and on-budget surpluses to these entitlement programs will "save" them, right?

- Wrong. And here is the dirty little secret. All of these funds do not go into a piggy-bank for future retirees. As ever, the money is loaned to the Treasury to either spend on other programs (during periods of deficits) or pay down the debt (as in the current period of surplus). In return for the loan, the government issues a debt instrument - an "IOU" to the trust funds. All of this works fine until.....

- 2015 for Social Security and 2009 for Medicare. Those are the dates when the Social Security and Medicare Board of Trustees estimate the programs will face cash deficits. In other words, payroll taxes will no longer cover benefits in each year.

- But what about those IOU's, and all of that surplus money we "saved"? Well, in order to pay that money back to the trust funds, the government will either have to raise taxes or reduce spending for other programs (or increase the deficit or reduce the surplus).

- Thanks to the recent surplus projections the promoters of the1/3 plan and others believe that if we could trim the tax cut, the government could pay down all of the redeemable debt and begin to accumulate assets as early as 2006 (by CBO estimates). The government would then liquidate those assets to pay the IOU's for Social Security and Medicare, avoiding other more painful choices.

- Putting aside the major problems and economic inefficiencies with the government accumulating assets, even if Congress saved every cent of the unified surplus we would accumulate $3.1 trillion in assets by the end of 2011. Most of those funds would not be accumulated until the last two years. In comparison, the Department of Treasury estimates that we would need about $6.8 trillion in cash today to fully fund Social Security and Part A of Medicare **(see note)**. However because of the time value of money, by the time we accumulate the $3.1 trillion in assets we will need closer to $11 trillion to fully fund those programs.

Note: This estimate does not include the unfunded liability for the Supplementary Medical Insurance, Part B of Medicare. This second Medicare trust fund gets an open-ended payment from the general fund of the government. CBO estimates that in 2001 this payment will total $70 billion, increasing to $177 billion by 2011. Without this general taxpayer support, Medicare – in total – would be running large deficits, not surpluses. Thus it would take more than $6.8 trillion to put all of Medicare plus Social Security on firm financial footing.

- Although saving all of the surpluses would certainly help out Social Security and Medicare, it must be carefully weighed against other policy options. For instance, do we really want entitlement spending to crowd out spending for all other programs? We already spend 7.5% of GDP on these entitlement programs for the elderly and CBO estimates that by 2040, without any policy changes, we will be spending 16.7% of GDP.

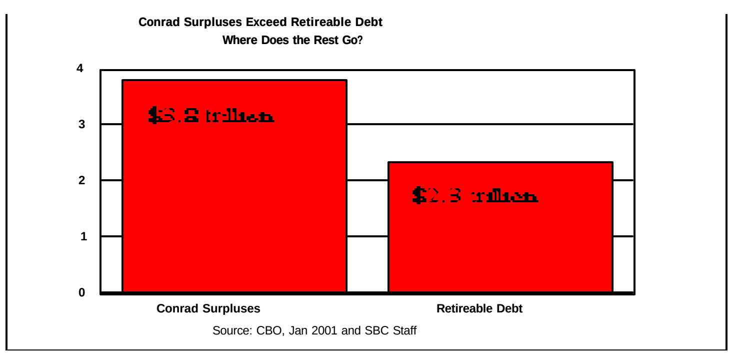
- The *Bulletin* suggests that saving 1/3, 2/3, or even all of the remaining on-budget surplus will not save Social Security and Medicare. And pretending that saving the surpluses will "save" these programs is simply a way to postpone dealing with the real structural problems both programs face. These programs were established during a time when the US had a large ratio of workers to retirees. Demographers almost unanimously agree that those conditions are gone forever. Reform of these programs is needed now, to safeguard our senior citizens and to avoid putting an undue burden on our working age population and our economy as a whole.

HIDING THE SURPLUS UNDER A MATRESS

- Last week Senator Conrad offered the "Social Security and Medicare Off-Budget Lockbox Act of 2001" as an amendment to the Bankruptcy bill. Had the amendment been adopted and signed into law it would have required Congress to set aside both the Social Security and Medicare Part A surpluses indefinitely, without exception, even for reforms to Medicare and Social Security. The Senate wisely defeated a motion to waive the budget act point of order against the amendment, and the amendment fell.

- Informed budgeteers know that CBO estimates that over the next 10 years the Social Security surpluses will amount to $2.5 trillion and the Medicare Part A surpluses to $0.4 trillion. In addition, Senator Conrad proposes setting aside 1/3 of the remaining $2.7 trillion on-budget surplus for debt reduction. The total amount the Conrad plan would set aside for debt reduction then is $3.8 trillion over the next 10 years.

- The chart below shows that the total amount (Part A of Medicare, Social Security, and 1/3 of the remaining on-budget surplus) saved under the Conrad plan over fiscal years 2002 through 2011 dwarf the total amount of debt available to retire. Of the estimated $3.1 trillion in debt held by the public at the end of fiscal year 2001, CBO estimates that only $2.3 trillion can be retired by 2011. (OMB estimates only $2 trillion can be retired by 2011.)



Source: CBO, Jan 2001 and SBC Staff

- Astute budgeteers will note that if the government were to accumulate $3.8 trillion in surpluses and could only retire $2.3 trillion in debt, then about $1.5 trillion in cash would be sitting at the Treasury by the end of 2011. What could the government do with these funds? Put them in a mattress? Invest them in the private sector?

- Neither option is a desirable public policy. The $1.5 trillion in accumulated cash would represent about 5% of the $31.6 trillion in total market capitalization of today. As Chairman Greenspan testified on January 25, "I believe, as I have noted in the past, that the federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government's investment decisions from political pressures. Thus, over time, having the government hold significant amounts of private assets would risk sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise."

- Chairman Greenspan is not the only influential person to oppose government accumulation of private industry. Two years ago, 99 Senators voted against direct government investment in private industry. (Sense of the Senate Amendment to the FY2000 Budget

Resolution, that the federal government should not invest the Social Security trust fund in the stock market.)

- Simply putting the cash in a mattress or other non-interest bearing account is not a reasonable option. US dollar currency in circulation is less than $600 billion worldwide and less than half of that is in the US. Back in the 1830's, the last time the debt was retired, the federal government deposited the money in banks favored by President Andrew Jackson, leading to a speculative bubble.

- Saving the Social Security surplus and Medicare Part A surplus, as well as 1/3 of the remaining on-budget surplus will not save our entitlement programs for the elderly, further the government is ill-suited to invest accumulations of cash balances. The Secretary of the Treasury should not be a mega mutual fund manager.

<u>"CONTINGENCIES" VERSUS "EXCESS BALANCES"</u>

- Since the release of the Bush budget proposal there has been some confusion between **"contingencies"** and **"excess balances."**

- The **contingencies** category in the Bush budget plan amounts to $842 billion and refers to the portion of the <u>on-budget</u> baseline surplus over the next 10 years that is not allocated for tax relief, higher spending, or paying the debt service associated with tax relief or higher spending. The contingency amount could be used for Social Security reform, additional tax relief, or increased spending.

- **Excess balances** refer to the accumulation of private assets that will theoretically start to occur when the unified budget surplus in a particular year exceeds the amount of the public debt that can be retired that year.

- Under the Bush budget proposal, the 10-year surplus will be $3.4 trillion – the baseline $5.6 trillion surplus having been reduced by $1.6 trillion for tax relief, about $200 billion for spending above the inflated baseline, and about $400 billion for debt service costs due to the tax relief and higher spending.

- Another way to think of this is that the $3.4 trillion unified surplus under the Bush budget proposal equals the $2.6 trillion Social Security surplus *plus* the $842 billion in contingencies (which comes from the on-budget surplus).

- Of this $3.4 trillion, $2 trillion will be used to reduce the public debt – the maximum possible reduction in debt during the 10-year budget window – and about $100 billion will be absorbed by direct loan financing accounts, which are another means of financing for the federal government.

- That leaves $1.3 trillion in surpluses. The Bush budget accounts for these monies by assuming the federal government would, starting in 2008, accumulate private assets that would pay interest at a Treasury rate. These are the "excess balances."

<u>CFO AGENCY AUDITS FOR FY00: A REVIEW</u>

- The 1990 Chief Financial Officers Act (CFO) requires the 24 largest federal departments and agencies to produce annual audited financial statements. While auditors gave clean opinions to only 11 agencies last year, 18 agencies recently received a clean audit opinion, the highest number ever.

- It is interesting to note that the Department of Treasury received its first clean, or "unqualified," opinion ever and the State Department recorded its first ever on-time opinion. Unfortunately, auditors are still unable to determine if the financial statements of the Agency of International Development, the Departments of Defense and Agriculture are reliable.

- Clean opinions on audited financial statements indicate sound financial management. But clean opinions don't present a complete picture of an agency's fiscal health.

- Receiving a "clean" audit does not mean the job of executive agencies is over. Rather, it is vital that agencies continuously work to improve internal controls and their financial and management systems.

- GAO reported last year that of the 24 agencies covered under the CFO Act, only the Energy Department, NASA and the National Science Foundation (NSF) fully complied with the financial requirements of the 1996 Federal Financial Management Improvement Act of 1996.

- In addition, GAO's High Risk Series Update released in January noted that most federal financial systems still are unable to produce reliable information and many agencies obtain clean audit opinions only through "heroic efforts" and "ad hoc procedures."

Federal Agencies' Financial Audit Results

Agency	FY00*	FY99	FY98
AID	Disclaimer	Disclaimer	Disclaimer
Agriculture	Disclaimer	Disclaimer	Disclaimer
Commerce	Unqualified	Unqualified	Unqualified**
Defense	Disclaimer	Disclaimer	Disclaimer
Education	Qualified	Qualified	Disclaimer
Energy	Unqualified	Unqualified	Qualified
EPA	Unqualified	Qualified	Unqualified
FEMA	Unqualified	Unqualified	Unqualified
GSA	Unqualified	Unqualified	Unqualified
HHS	Unqualified	Unqualified	Qualified
HUD	Unqualified	Disclaimer	Unqualified
Interior	Unqualified	Late	Unqualified
DOJ	Qualified***	Qualified	Disclaimer
Labor	Unqualified	Unqualified	Unqualified
NASA	Unqualified	Unqualified	Unqualified
NSF	Unqualified	Unqualified	Unqualified
Nuclear Reg. Comm.	Unqualified	Unqualified	Unqualified
OPM	Unqualified	Disclaimer	Disclaimer
SBA	Unqualified	Unqualified	Unqualified
SSA	Unqualified	Unqualified	Unqualified
State	Unqualified	Late	Unqualified
Transportation	Qualified	Late	Disclaimer
Treasury	Unqualified	Qualified	Qualified
VA	Unqualified	Late	Qualified

* An *unqualified* opinion means the agency's financial statements were reliable. A *qualified* opinion means segments of the statements were not reliable. A *disclaimer* of opinion means the auditor could not determine if the information in the statement was reliable. *Late* means the agency did not turn its financial statement on time. ** Commerce received an unqualified opinion on its balance sheet and a disclaimer on all other financial statements. *** DOJ received an unqualified opinion on its balance sheet and custodial activity statement for FY00.

CALENDAR

Senate Budget Committee Hearing Schedule

March 22: Debt Management; Witnesses: Gary Gensler, Former Undersecretary for Domestic Finance, Department of Treasury; Ward McCarthy; Managing Director, Stone & McCarthy Research Associates; Edwin M. Truman, Senior Fellow, Institute for International Economics; Additional Witnesses to be Determined. Dirksen 608, 11:00 am.