



CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, DC 20515

Dan L. Crippen
Director

May 11, 2000

Honorable Phil Gramm
United States Senate
Washington, DC 20510

Dear Senator Gramm:

In your letter of March 24, you asked the Congressional Budget Office (CBO) to analyze how the President's Social Security proposal (described in the budget for fiscal year 2001) would affect the outlook for the federal budget beyond the 10-year horizon CBO usually uses for its projections. (CBO's estimates of the budgetary effects of the President's proposal during the first 10 years can be found in Chapter 3 of *An Analysis of the President's Budgetary Proposals for Fiscal Year 2001*, published in April 2000.)

As you know, the federal budget will face increasing pressures in coming decades as the baby-boom generation retires and begins to draw Social Security and Medicare benefits. The Social Security program will be squeezed from both sides of the ledger: the growth of revenues will slow as baby boomers leave the workforce, and outlays will grow as the boomers begin to claim benefits. Similar pressures will arise in the federal government's health programs for the aged, which will face growing enrollments and rising costs per beneficiary. Over time, such pressures could cause the federal debt to rise and slow the growth of the economy. That scenario has stimulated a great deal of interest in alternative approaches for addressing the problems posed by the retirement of the baby-boom generation.

The President's Social Security proposal consists of four main parts, but only the first two would affect the Social Security program directly. The proposal would:

- o Make transfers from the general fund to the Social Security trust funds starting in 2011;

- o Invest half of the transfers in corporate equities (but no more than 15 percent of the total assets in the trust funds);
- o Extend the existing budget enforcement laws from their currently scheduled expiration in 2002 to 2010 and raise the caps on discretionary spending; and
- o Set up unspecified procedural hurdles in the legislative process that would make it more difficult to enact legislation that might lead to on-budget deficits.

In addition, the President's budget notes the Administration's commitment to repealing the Social Security earnings test (which defers payments to people under the age of 70 who continue to work after they have begun drawing benefits) and to improving benefits for older women; however, it does not include those proposals in the budget figures. (Public Law 106-182, enacted in April 2000, repealed the earnings test for individuals who have attained retirement age.) Finally, the President has also expressed interest in working with the Congress to close Social Security's financing gap, but he has not submitted any specific legislation to achieve that goal.

The President's proposal to *make transfers from the general fund to the trust funds* would have no direct effect on the overall budget for the same reason that people cannot make themselves wealthier by simply transferring a dollar from one pocket to another. The transfers are nothing more than intragovernmental accounting transactions. And although they would improve the solvency of the trust funds, they would not directly change the government's ability to pay its obligations. Today's lawmakers can make a given set of obligations more affordable for future generations by taking actions that enhance economic growth. Reducing debt held by the public is one of the most effective ways of increasing national saving and investment. However, the President's proposed transfers would simply create transactions between government accounts. By themselves, such intragovernmental transfers do not increase the total resources available to the government.

The transfers could have indirect effects on the budget, however, if they changed people's perceptions about the Social Security program and altered future decisions by policymakers. The direction of those effects is uncertain. On one side, the proposed transfers might help package debt reduction in a more palatable form. The transfers would reduce on-budget surpluses and correspondingly increase off-budget

surpluses. As long as the Congress and the President remained committed to maintaining Social Security's off-budget surpluses, the transferred amounts might be less vulnerable to proposals to increase spending or reduce taxes.

On the other side, the improvement in the program's actuarial balance could lull the public into a false sense of complacency about the program, which could lessen political pressure for reforming Social Security in the near future, when corrective actions would be less painful. The transfers would make Social Security appear healthier, but because they would not enhance economic growth or reduce future obligations, they would not strengthen in any real sense the government's ability to pay future benefits. Whether tomorrow's taxpayers will agree to provide the resources necessary to maintain current-law benefits will not depend on trust fund balances but on general economic conditions and spending priorities within the overall budget at that time.

Although the President's proposal to *invest in equities* would probably reduce the average level of federal net indebtedness in the long term, it would do so at the cost of higher risk. As a result, equity investments would not improve the government's overall fiscal condition after adjusting for risk using market valuations. The average rate of return from large-company stocks from 1926 to 1998 was about 6 percentage points above the rates of return from intermediate-term government bonds. Given the high price-to-earnings ratios in today's markets, though, that equity premium may be smaller in the future. In addition, because corporate equities present commensurately higher risk, investing a portion of the Social Security trust funds in that way would increase the fluctuations in the federal government's finances.

Investing the trust funds in equities also raises concerns about the government's involvement in the private sector. What are the implications of the government's owning a portion of U.S. companies? Would its involvement distort market signals and managerial decisions? Could the government fully insulate its decisions about buying and selling stocks from the political process? Those questions warrant answers before investing the Social Security trust funds in corporate equities.

The effect of *extending existing budgetary enforcement laws and raising the caps on discretionary spending* is uncertain because of the difficulty in determining what policymakers would do without those restraints. Because discretionary spending is not specified in advance—instead, it proceeds from action on annual appropriations—any current-law baseline carries a certain amount of ambiguity. The

Honorable Phil Gramm

Page 4

path for discretionary spending in the President's proposed extension is similar to that in the "inflated" version of CBO's baseline, which assumes that discretionary spending grows with inflation after 2000. Thus, the long-term effects of this aspect of the President's proposal are small relative to that baseline. But the caps that the Administration has proposed represent a major increase relative to the paths for discretionary spending that correspond to the current caps or to a freeze. Thus, whether the proposed caps represent budgetary restraint or expansion depends on one's assumption about the likely path of discretionary spending in the caps' absence.

Also uncertain is the impact of *setting up procedural hurdles* to discourage legislation that would lead to on-budget deficits. Such mechanisms would succeed only if they actually influenced decisionmakers' behavior. The history of the fixed deficit targets in the Balanced Budget and Emergency Deficit Control Act of 1985 shows that achieving bottom-line targets can be a difficult task.

I hope this information is useful. Please feel free to call me if you have any questions, or have your staff contact Douglas Hamilton.

Sincerely,

Dan L. Crippen
Director