"The Budget and Long-term Fiscal Policy"

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Introduction

It is a pleasure to appear before the Committee today to discuss the impact of demographic trends on the budget and long-term fiscal policy. The country has recently enjoyed a remarkable period of economic prosperity: During the late 1990s, output per hour in the nonfarm business sector grew at almost double its rate between the early 1970s and the mid-1990s, and the unemployment rate hovered at around 4 percent without any significant sign of an acceleration in prices.

In large part due to this strong economic performance, the country faces the possibility of large projected budget surpluses. The most recent projections from the Congressional Budget Office (CBO) suggest a baseline unified budget surplus of slightly over 4 percent of GDP, and an on-budget surplus of more than 2.2 percent of GDP, between 2002 and 2011.[2]

Even if these projections turn out to be correct, however, the surpluses are expected to be temporary. The coming retirement of the baby boomers, ongoing reductions in mortality rates, and expensive -- albeit socially beneficial -- improvements in medical technology are expected to place increasing pressure on the Federal budget over time. In October 2000, CBO projected that spending on Social Security, Medicare, and Medicaid would rise from 7.5 percent of GDP in 1999 to over 16.7 percent in 2040.[3] Such a dramatic increase in outlays for these three programs represents a significant fiscal challenge.[4]

Given these projections of large, but temporary, budget surpluses, I want to highlight four key issues in my testimony this morning:

- First, the importance of national saving in reducing the relative burden of meeting our future obligations;

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[2] The on-budget surplus excludes Social Security and the Postal Service.

[3] Congressional Budget Office, "The Long-Term Budget Outlook," October 2000.

[4] It is worth noting that the changes in CBO's medium-term forecast since last October do not significantly affect the basic conclusion that in the longer term, substantial budget challenges remain.

- Second, and perhaps most crucially, the tradeoffs inherent in current projections between higher national saving and the avoidance of any public investment in private assets;

- Third, the experiences to date of state and local public pension funds, along with foreign governments, in managing private-sector investments; and

- Finally, the implications of uncertainty in both budget and Social Security projections.

To summarize my most important conclusions:

- Higher national saving offers the most effective available policy response to our aging population.

- Forgoing national saving to avoid any public investment in private assets would potentially entail significant costs in terms of future output. My back-of-the-envelope estimates suggest that saving the projected off-budget surplus, the projected Hospital Insurance surplus, and one-third of the projected on-budget surplus between 2002 and 2011 would raise real GDP by roughly $200 billion in 2012 relative to undertaking no public saving in the meanwhile. Our nation's capital stock by the end of 2011 would be well over $2 trillion higher than if we failed to save any of the projected surpluses.

- The relative scale of projected public investment in private assets, even if the current budget projections turn out to be accurate, are small in comparison to activities already undertaken by state and local pension funds in the United States, and by foreign governments such as Denmark and Norway. State and local pension funds in the United States already own almost $2 trillion in corporate equities, and Denmark has successfully invested its public pension fund in private assets for decades.

- Current forecasts involve significant uncertainty, highlighting the benefits of caution before dissipating all of the projected budget surpluses in tax cuts or spending increases.

National saving

The most effective approach to reducing the relative burden of our future budgetary obligations is to raise national saving. The fundamental benefit of higher national saving is that it will provide additional resources with which to pay retirement benefits and health care for future retirees. These additional resources then ease the relative burden on future workers in making good on the promises that we have made to current workers.[5]

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[5] Higher national saving today increases future gross domestic product (if the increase in national saving is absorbed through higher domestic investment) or future receipts from abroad (if the increase in national saving is absorbed through higher net lending to foreigners, or equivalently a larger current account balance). Either way, the burden imposed on future domestic workers in providing a given level of retirement income and health care to

In the United States, net national saving has risen substantially over the past seven years, from 3.4 percent of GDP in 1993 to 6.0 percent in 1999. The improvement in Federal saving -- that is, the contribution of the Federal budget to the pool of national saving -- more than explains the entire improvement.[6]

Further increases in national saving through continued improvements in the contribution of the Federal budget -- that is, running larger budget surpluses -- offers the most promising, although imperfect, remedy to the fiscal challenge of our aging population. In other words, the most effective fiscal policy response to meeting our future budgetary burdens is to save the projected surpluses. As the Congressional Budget Office noted in October, "'Saving' most or all of the budget surpluses that CBO projects over the next 10 years – using them to pay down debt – would...substantially delay the emergence of a serious fiscal imbalance."[7]

The "peril of zero debt" and tradeoffs between national saving and capital market efficiency[8]

In testimony before the Senate Budget Committee on January 25, Alan Greenspan noted that the projected medium-term unified budget surpluses are so large that the readily available publicly held debt may be eliminated within the ten-year budget window. The implication would then be public investment in some sort of private assets.

Chairman Greenspan further argued that allowing the government to hold 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."[9] Therefore, he appeared to conclude, we must find some means of dissipating at least part of the projected surpluses in order to avoid such investments. Given the significant benefits of higher national saving in preparing for the retirement of the baby boomers, this argument is worthy of careful scrutiny. As a first step, I have undertaken some simple calculations that I hope will clarify some of the tradeoffs involved.

Using the most recent CBO projections, I examined four alternative proposals: saving the off-budget surplus only, saving the off-budget surplus plus the surplus in the Hospital Insurance (HI)

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today's current workers is reduced.

[6] Federal saving has moved from negative 4.1 percent of GDP in 1993 to positive 1.3 percent of GDP in 1999, a net shift of 5.4 percent of GDP. At the same time, private saving has fallen by 3.4 percent of GDP, and state and local government saving has risen by just 0.5 percent of GDP.

[7] Congressional Budget Office, "The Long-Term Budget Outlook," October 2000.

[8] The "peril of zero debt" phrase is taken from Alice M. Rivlin, "Why Fight the Surplus?" *New York Times*, January 30, 2001, page A23.

[9] Alan Greenspan, "Outlook for the federal budget and implications for fiscal policy," Testimony before the Committee on the Budget, U.S. Senate, January 25, 2001.

component of Medicare, saving the off-budget surplus plus the HI surplus plus one-third of the projected on-budget surplus (excluding the HI component), and saving the entire projected surplus. I compared these proposals with saving none of the projected unified surpluses. The table below summarizes the results.

The final row shows that saving the off-budget surplus, the HI surplus, and one-third of the projected on-budget surplus between 2002 and 2011 would raise real GDP by almost $200 billion in 2012 -- or more than one percent -- relative to not saving any of the surplus. The capital that Americans would have to draw upon in 2012 would be $2.8 trillion higher in nominal dollars and $2.3 trillion higher in constant (inflation-adjusted) dollars than if we failed to save any of the projected surpluses. Limited public investments in private assets, to the extent that they permit higher national saving than would be possible in their absence, thus facilitate significant economic benefits.

I should emphasize that these estimates are based on back-of-the-envelope calculations. More complicated calculations, however, seem unlikely to produce grossly different results.[10]

Despite the conservative nature of these simple calculations, they illustrate a real cost to forgoing national saving to avoid public investments in private assets.[11] To argue that avoiding any public investment in private assets is more important than raising national saving, one must believe that the negative impact on the efficiency of our capital markets from such public investments would amount to inefficiencies of hundreds of billions of dollars or more per year.[12]

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[10] Two factors suggest that the estimates may, if anything, be conservative. First, the effects of a higher saving path would grow over time relative to a lower saving path, but this analysis is limited to the impact in 2012. Second, they do not incorporate any "endogenous growth" effect from increased saving, which would produce larger effects on GDP. (In "endogenous growth" models, an increase in the saving rate would produce dynamic benefits, such as increased innovation.) The marginal product of capital assumption, taken from Feldstein and Samwick, may be too high, especially since a constant marginal product is applied despite the increase in the capital stock. But the qualitative results are not substantially affected by a lower marginal product of capital assumption: For example, with a 7 percent marginal product of capital, the impact on real GDP in 2012 from saving the off-budget surplus, the HI surplus, and one-third of the on-budget surplus is $160 billion, rather than $193 billion.

[11] It may also be worth noting that public investments in private assets could be attenuated, or in some cases avoided, by paying a higher premium for the publicly held debt that investors value at significantly more than its current market value. In other words, some investors may particularly value the safety of U.S. Treasury securities, and therefore value them more highly than their current market price. To retire the debt held by such investors, the U.S. government would be forced to pay a premium to induce the investors to sell the debt back to the government. Nonetheless, to the extent that the tradeoff is between paying a premium for such debt or dissipating the funds and thus reducing public saving, such premium payments may represent sound policy.

[12] A full social cost-benefit analysis would also take into account the cost of the consumption forgone to produce the higher national saving. The focus of this analysis is merely future output, as a proxy for the resources available to meet future obligations, rather than a full social cost-benefit analysis.

Amount devoted to saving (debt reduction):	None of the projected surpluses, 2002-2011	Off-budget surplus only, 2002-2011	Off-budget plus HI surpluses, 2002-2011	Off-budget, HI, and one-third of on-budget surplus, 2002-2011	Entire unified surplus, 2002-2011
Net debt of Federal government at end of 2011 (nominal $, in billions)	$3,148	$776	$383	-$526	-$2,346
Gross Federal holdings of private assets at end of 2011 (as % of baseline GDP)[13]	NA	0.2%	2.5%	7.9%	18.5%
Increase in capital stock (including stock of net foreign investment) at end of 2011, relative to no saving (nominal $, in billions)[14]	$0	$1,779	$2,073	$2,756	$4,121
Real GDP in 2012 (2001$, in billions)[15]	$14,292	$14,417	$14,438	$14,486	$14,582
Increase in real GDP in 2012 (2001$, in billions), relative to no saving	$0	$125	$146	$193	$289

[13] Assumes that $818 billion in publicly held debt is not available for repurchase at the end of 2011, as estimated by CBO in its most recent projections. The asset holdings for the various cases are expressed for simplicity relative to a single value of nominal GDP in 2011 ($17,132, as under the CBO baseline).

[14] Assumes that 25 percent of any increase in net government debt is offset by increases in private saving. Such an offset could arise from various reasons, including the increases in private saving due to neo-Ricardian effects (under which individuals save more in anticipation of higher future taxes to service the additional debt) and increase in private saving in response to reductions in personal income taxes. (Note that the decomposition of any increase in national saving between increases in the domestic capital stock and increases in net foreign investment is not of first-order importance, under the assumption that the return on the domestic capital stock is approximately equal to the return on net foreign investment.)

[15] Assumes a marginal product of capital of 8.5 percent, as assumed by Martin Feldstein and Andrew Samwick in evaluating individual accounts. See Martin Feldstein and Andrew Samwick, "Allocating Payroll Tax Revenue to Personal Retirement Accounts," *Tax Notes*, June 19, 2000, p. 1645. Also assumes that CBO's 3.1 percent real growth rate for 2010 and 2011 is continued into 2012. Note that it is technically more accurate to examine Gross National Product, rather than Gross Domestic Product, since some of the differentials in capital are likely to manifest themselves in the stock of net foreign investment rather than the stock of domestic capital. Under the assumption that the return on foreign capital is equal to the return on domestic capital, however, this caveat is merely semantic: The benefit to future workers is unaffected.

The evidence on public pension investments in private assets

Public investments in private assets carry risks. The benefits of increased national saving, however, may well outweigh the costs of limited public investments in private assets, especially if those investments were undertaken through the Social Security system rather than a generic budget account, and through an independent board, with private investment managers and substantial protection against political interference. Given the experience of state and local pension funds in the United States, and national trust funds in other developed countries, including Denmark and Norway, it seems unlikely that limited Social Security investments in private assets – for example, amounting to no more than 10 percent of GDP or so – would generate efficiency losses of hundreds of billions of dollars a year.[16]

In the United States, state and local public pension funds have long invested in private assets. At the end of the third quarter of 2000, the most recent data available, state and local pension investments in private assets (including bonds and other assets) amounted to 28 percent of GDP, and state and local pension investments in corporate equities amounted to almost $2 trillion, or 19.5 percent of GDP.[17] This scale is likely beyond that which the Federal government would undertake, yet has not endangered the efficiency of our private capital markets -- despite the fact that state and local funds generally lack the institutional protections, such as fully independent boards and a passive management strategy, that would presumably be part of any sound proposal for investing Social Security funds.

Recent research suggests that state and local pension funds now perform relatively well. Alicia Munnell and Annika Sunden of Boston College recently concluded that, "the story that emerges at the state and local level is that while in the early 1980s some public plans sacrificed returns for social considerations, plan managers have become much more sophisticated. Today, public plans appear to be performing as well as private plans."[18] State and local pension funds now devote no more than 2.5 percent of their total holdings to "economically targeted investments" (the ones that could reflect political interference), the vast majority of state and local funds do not engage in shareholder activism (and the ones that do appear to be motivated by improving their financial performance, rather than political interference), and divestiture based on political grounds has largely

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[16] Under the (unrealistic) assumption of perfect capital markets, the government could not possibly earn a sub-market risk-adjusted rate of return nor cause inefficiencies. For further discussion, see Peter Orszag and Joseph Stiglitz, "Rethinking Pension Reform: Ten Myths about Social Security Systems," in R. Holzmann and J. Stiglitz, eds., *New Ideas about Old Age Security* (The World Bank: forthcoming).

[17] Data from Table L.120 of the Flow of Funds Accounts, December 8, 2000, available at www.federalreserve.gov. At the end of Q3 2000, state and local government employee retirement funds held a total of $3.034 trillion in financial assets, of which $208.9 billion was in U.S. Treasury securities and $1.7 billion was in municipal securities. Financial assets representing claims on the private sector thus amounted to $2.824 trillion, or 28 percent of Q3 GDP ($10.039 trillion). Of this total, $1.95 trillion was held in the form of corporate equities.

[18] Alicia Munnell and Annika Sunden, "Investment Practices of State and Local Pension Funds: Implications for Social Security Reform," Center for Retirement Research, Boston College, CRR WP 1999-01, April 1999, page 3.

been limited to South Africa before 1994. Munnell and Sunden also note that, "In our view, it is particularly remarkable that so little social investing has taken place at the state and local level given that many of these public plans lack the federal protections afforded corporate pension plans and those envisioned for possible Social Security equity investment."[19]

The experiences of foreign governments in managing private investment is also encouraging.[20] For example, Canada has recently changed the regulations governing its Canada Pension Plan to allow that system to invest a portion of its reserves in private assets. The investments are governed by an independent investment board comprising 12 members, each of whom will serve a three-year term. The board is currently investing in stock funds that replicate the TSE 300 Index on the Toronto Stock Exchange, the S&P 500 Index for large public companies in the United States, and the EAFE Index of about 1,300 companies in Europe, Australasia and the Far East (last year, it invested roughly 80 cents of every new dollar in the TSE 300 fund and 10 cents each in the U.S. and foreign funds).[21]

It is still too early to know how well the Canadian approach will work. But other developed countries have shown that they can successfully invest in private assets over extended periods of time. In Denmark, for example, the ATP fund is a public pension fund whose assets amount to 25 percent of GDP. It invests largely in Denmark, including in stocks, corporate bonds, and mortgage securities. It has very low expenses (annual costs are about 10 basis points, or 0.1 percent, of assets under management, relative to an average of about 150 basis points for mutual funds in the United States). Perhaps more importantly, there is no evidence of political interference in its decision-making. Indeed, the fund is so successful that private pension funds in Denmark have began hiring it to administer their investments.[22] Norway's State Petroleum Fund, with assets of more than 15 percent of GDP, is also widely anticipated to be used to pay off social security obligations. The State Petroleum Fund invests largely in foreign bonds, and has achieved a successful investment record.[23] Switzerland has also invested in private securities.

The Federal Thrift Savings Plan provides yet another example of successful private

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[19] Munnell and Sunden, page 35.

[20] It should be noted that in many developing countries, the experience with trust fund investments has been poor: The investments have been politicized, and the trust funds have been mismanaged. See, for example, the discussion in the World Bank, *Averting the Old Age Crisis* (1994). It is not clear, however, that the experiences in developing countries is relevant to the United States.

[21] For more on the investment board in Canada, see http://www.cppib.ca.

[22] For more on the ATP fund in Denmark, see Tryggvi Thor Herbertsson, J. Michael Orszag, and Peter R. Orszag, *Retirement in the Nordic Countries: Prospects and Proposals for Reform*, prepared for the Nordic Council of Ministers, May 2000, available at http://www.sbgo.com, page 65.

[23] See International Monetary Fund, *Norway: Selected Issues*, February 1999, IMF Staff Country Report 99/11.

investments by a public entity. Francis Cavanaugh, the first executive director of the Federal Retirement Thrift Investment Board (which oversees the Thrift Savings Plan's investments), noted in a 1999 interview that, "The question is not can it be done. The question that should be asked is whether the Congress, having protected three million Federal employees from political manipulation of their retirement funds, will be willing to extend that same protection to the 150 million beneficiaries of Social Security."[24] In answering that question, it is worth noting that there are a number of examples in which the public sector has effectively managed pension investments in private assets without undue politicization.

The effects of uncertainty

Finally, I would like to touch briefly on the impact of uncertainty on budget and actuarial projections. The substantial shift over the past few years in the projected Federal budget balance, along with a somewhat less dramatic shift in the projected long-term imbalance within Social Security, highlights the uncertainty associated with medium- and long-term forecasts. This uncertainty is recognized by the forecasters themselves: CBO included an entire chapter on uncertainty in its most recent set of projections, and Social Security's actuaries regularly produce three sets of projections (low cost, intermediate, and high cost) in an attempt to capture some of the uncertainty surroundings their actuarial estimates.

In the budgetary world, the CBO projections suggest about a 20 percent chance that the budget excluding Social Security and the HI component of Medicare will be in deficit each year from 2002 to 2006. Furthermore, the projected budget surpluses are backloaded: more than 70 percent of the projected on-budget surplus outside of HI accrues in the second five years of the budget window.

One sound approach to recognizing forecast uncertainty has been advocated by Robert Reischauer, the respected former director of CBO who is now president of the Urban Institute. Reischauer's proposal would make available for either tax cuts or spending increases a declining percentage of the projected surplus in each future year, to reflect the greater degree of uncertainty as the forecast horizon increases. In particular, under the proposal, the first step would be to exclude those components of the surplus – for example, the Social Security and HI components – that would not be spent. Tax cuts or spending increases could then consume no more than 80 percent of the remaining surplus in the first and second years, 70 percent in the third and fourth years, 60 percent in the fifth and sixth years, and so on. Eventually, the vast majority of the available surplus would be available for tax cuts or spending increases, but only slowly over time**.**

The Reischauer proposal, and other similar ones, are worth serious examination. At the very least, we have time to wait two or three years before concluding that the peril of zero debt is imminent and committing large portions of the projected surpluses to tax cuts or spending increases.

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[24] "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, page 16.

In Social Security, the uncertainties are even more challenging. Some analysts have used the uncertainty over long-term Social Security costs to argue that we should wait and do nothing today. But that is surely as unwise a response to the uncertainty as adopting irrevocable policies today.[25]

Sound fiscal policy over the next decade is fully consistent with sound Social Security policy. In particular, some portion of the on-budget surplus should be earmarked for transfers to the Social Security system. Such transfers bolster both national saving and the Social Security program.

Conclusion

The emergence of temporary, but large, projected budget surpluses presents the nation with a promising opportunity to better prepare for the longer-term challenges associated with the retirement of the baby boomers, increased life expectancies, and ongoing innovations in medical technology. The surpluses can raise national saving, which then provides the nation with additional resources to meet these challenges in the future.

The cost of forgoing national saving is high, especially in the face of significant uncertainty about long-term budgetary costs. Moreover, it is unclear whether the "peril of zero debt" will even come to pass within the foreseeable future. For now, I would urge you to preserve a significant portion of the projected budget surpluses for the purpose of raising national saving.

Thank you.

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[25] J. Michael Orszag and Peter R. Orszag, "The Benefits of Flexible Funding: Implications for Pension Reform in an Uncertain World." *Annual Bank Conference on Development Economics 2000* (The World Bank, forthcoming).