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Saving for a Rainy Day

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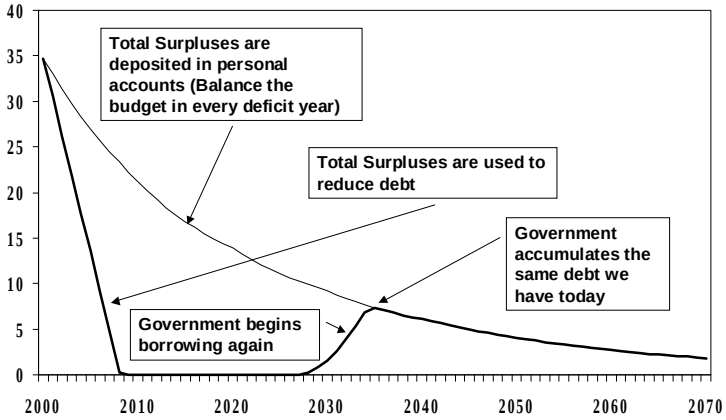
In its January forecast, the Congressional Budget Office (CBO) projected budget surpluses totaling $5.6 trillion between 2002 and 2011, up from $4.6 trillion a year earlier. This forecast assumes (1) no tax cut, (2) no spending increase and (3) no Social Security privatization. The forecast therefore assumes that the surpluses will be used to pay down the government debt available for repurchase and then buy assets that earn a return similar to that earned on Treasury issues. This means that beginning in 2006, the government would do something it has never done: accumulate and hold significant levels of private financial assets.

Why the Government Is Expected to Hold Private Assets. CBO forecasts also show that by 2011 the government's debt will diminish to $818 billion, less than a quarter of the current $3.4 trillion. Further, while waiting for its debt to mature (so it can be repurchased), the government will accumulate assets totaling $3.2 trillion. In 10 years, if everything goes according to schedule, the government's assets will exceed its debts by $2.3 trillion. These assets, initially in the form of cash, could in principle be used to purchase corporate bonds and stocks.

FIGURE I

Federal Debt Held by the Public as a Percentage of GDP



The CBO forecast implies that in principle tax increases or additional borrowing could be delayed until 2050. Specifically:

- The government savings account will approach 50 percent of the nation's output by 2030, thanks to 20-plus years of surpluses.
- Once the surpluses end, the government will sell some of its assets in each year to make up for the revenue shortfall.
- By 2050 the savings will be completely depleted, necessitating additional taxes or borrowing.

Should Government Hold Private Assets? Even with the conservative rates of return assumed in the CBO forecasts, the government could postpone tax increases or additional borrowing for a long time. But there is a long history of opposition to the government's holding private financial assets.

Back in the late 1930s, an Old Age Reserve Account was proposed to accumulate assets for the fledgling Social Security program. The debate focused on the prospect of the government's involvement in the private financial market. Opposition to a large, centrally held account led to the system's being financed on a pay-as-you-go basis rather than being funded.

Today there are again concerns about the government holding assets. In January, Federal Reserve Chairman Alan Greenspan, voicing concern that political considerations could affect investment decisions, said the government should avoid holding private assets. Greenspan suggested that a better use of the surpluses would be to fund individual retirement accounts or, barring that, tax cuts.

Using All Surpluses for Personal Retirement Accounts. Unlike the explicit federal debt, the government's future commitments under such programs as Social Security and Medicare are not counted as part of the outstanding debt of the United States. But these implicit debts are debts just the same.

In the CBO forecasts, surpluses are used to retire the government's explicit debts. But these same surpluses could be placed in personal retirement accounts (PRAs) which would replace government's obligation to pay benefits during the retirement years. In this way, PRA

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deposits could be used to "retire" the government's implicit debts.

Putting the entire Social Security and non-Social Security surpluses into personal retirement accounts would produce economic benefits similar to those arising from paying down the government's explicit debt. With PRAs, savings will increase, which increases the nation's productive capabilities, and as a result America's output will grow. Tax increases and/or additional borrowing can be postponed until at least 2050, the same year as in the CBO's estimates.

Results of Alternative Approaches. The accompanying figures depict the consequences of either (1) paying down the explicit federal debt and then using remaining surpluses for tax cuts or spending increases or (2) depositing the surpluses in private accounts that substitute for the government's obligations to pay benefits. Figure I depicts the time path of the explicit debt as a percent of GDP under the two alternative strategies. The top line shows the path of the explicit debt if all surplus funds are used to reduce the implicit debt by depositing them in personal retirement accounts. Because GDP increases over time and the explicit debt remains constant, the explicit debt falls as a percent of GDP.

The bottom line in Figure I shows what happens if the surpluses are used to retire the explicit debt:

- The net debt is zero in 2008.
- The government must begin to borrow again starting in about 2028.
- Between 2028 and 2035 borrowing reaches the same nominal debt we have today.
- From 2035 on, the debt level is the same under both alternatives.

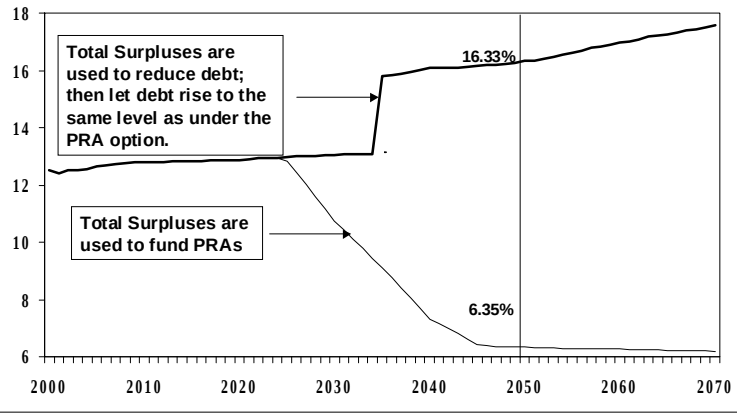
Figure II depicts the Social Security payroll tax rates required under the two scenarios, assuming the debt schedules depicted in Figure I. The top line shows the rates if the surpluses are initially used to retire debt. With the debt paid off in 2008, any tax cuts between 2008 and 2028 are assumed to be general revenue tax cuts, not payroll tax cuts. Beginning in 2035, the year in which the debt levels under the two scenarios are equal, the payroll tax is increased to cover the cost of paying Social Security benefits.

The lower line shows the payroll tax rates if all of the surpluses are deposited in personal retirement accounts.

- Beginning in 2025, the payroll tax rate can be reduced.
- By 2050, the payroll tax rate falls to 6.35 percent compared to the 16.33 percent required without prefunding.

FIGURE II

Necessary Social Security Tax Revenues Expressed as a Percent of Payroll



Conclusion. The budget surpluses provide a unique opportunity. By using all of the budget surpluses to fund personal retirement accounts, we could go a long way toward prepaying Social Security. The long-run Social Security payroll tax could be reduced 60 percent from the level that would be required if today's surpluses are used instead to pay down debt. There are of course other options. The surpluses could be used to fund tax cuts and spending increases. But the point of this exercise is to suggest that by taking advantage of the surpluses it is possible to address the greatest fiscal challenge that awaits the nation.

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