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Douglas W. Elmendorf, Jeffrey B. Liebman and David W. Wilcox
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ABSTRACT

This paper reviews the course of fiscal policy and Social Security policy during the 1990s. The 1990s witnessed two fundamental changes in U.S. fiscal policy: a dramatic improvement in the current and projected budget balance, and a shift to a new political consensus in favor of balancing the budget excluding Social Security rather than the unified budget. The dramatic improvement in the budget outlook stemmed both from favorable developments in the economic environment and from deliberate policy actions that reduced budget deficits and later did not spend down the surpluses.

In contrast, the 1990s did not witness significant changes in Social Security policy, although alternative visions of Social Security reform received tremendous analytic and popular attention. The 1994-1996 Advisory Council on Social Security presented three reform plans that placed important emphasis on additional prefunding. Each involved some form of investment in equities – either centrally, through the trust fund, or in a decentralized manner, through individual accounts. Late in the decade, with the emergence of on-budget surpluses, the possibility of general revenue contributions to the Social Security system came under serious consideration. In the end, President Clinton decided to pursue Social Security reform based on general revenue contributions to the trust fund and centralized investment in equities rather than creating individual accounts, but his proposal was not adopted.

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1. Introduction

The 1990s witnessed two fundamental changes in U.S. fiscal policy: a dramatic improvement in the current and projected budget balance, and a shift to a new political consensus in favor of balancing the budget excluding Social Security rather than the unified budget. In contrast, the 1990s did not witness significant changes in Social Security policy, although alternative visions of Social Security reform received tremendous analytic and popular attention. This paper reviews the course of fiscal policy and Social Security policy during the 1990s, including the economic and political forces that changed fiscal policy and left Social Security policy largely unchanged.

In January 1990 the Congressional Budget Office (CBO) projected that the unified budget deficit would exceed \$100 billion during the fiscal year then under way and would remain at about that level for the following five years. Two years later, the CBO projected that the budget deficit would hit \$350 billion in fiscal year 1992, fall by half over the following four years, and then turn up again to pass \$400 billion in 2002.¹ Yet, by January 2001, the budget had recorded its third consecutive unified surplus, and the CBO projected that, under unchanged law, unified surpluses would total more than \$5.5 trillion over the next decade. This dramatic in the budget outlook stemmed both from favorable developments in the economic environment and from deliberate policy actions that reduced budget deficits and later did not spend down the surpluses.

The second respect in which the fiscal landscape was transformed during the 1990s was in the presumed standard for determining whether the federal government was living within its means. Until the past few years, debate and decisionmaking about the federal budget almost

¹ The CBO was too pessimistic about FY1992: the unified deficit that year came in at \$290 billion.

invariably were conducted in terms of the unified budget, and the fiscal objective was generally assumed – either implicitly or explicitly – to be balance in the unified budget. But in the summer of 1999, buoyed by the progress of the preceding several years, the political consensus shifted suddenly and dramatically to the objective of balancing the budget excluding the current operations of the Social Security system, while aiming to put Social Security into 75-year actuarial balance. This change has had important implications for the political conversation about the budget. For example, in early 2001 Congress debated the disposition of roughly \$3.1 trillion in projected on-budget surpluses over the next ten years rather than \$5.6 trillion in unified surpluses. The disposition of roughly \$2.5 trillion in projected Social Security surpluses essentially was not disputed; virtually everyone assumed that they would be used to pay down debt held by the public.

Changes of comparable magnitude did not occur in Social Security policy during the 1990s, although significant reforms of the program were debated at great length. It has been clear for some time that the aging of the U.S. population will eventually require significant changes in Social Security revenues or benefits. The reforms enacted in 1977 and 1983 set payroll tax revenues above contemporaneous outlays, so that future benefits could be partly prefunded through an accumulation of assets in the Social Security trust fund. The 1994-1996 Advisory Council on Social Security presented three reform plans that placed important emphasis on additional prefunding. Each involved some form of investment in equities – either centrally, through the trust fund, or in a decentralized manner, through individual accounts. Late in the decade, with the emergence of on-budget surpluses, the possibility of general revenue contributions to the Social Security system came under serious consideration. In the end,

President Clinton decided to pursue Social Security reform based on general revenue contributions to the trust fund and centralized investment in equities rather than creating individual accounts, but his proposal was not adopted.

The remainder of the paper explores these themes more closely. The second section summarizes the changing budget outlook, and the subsequent sections proceed chronologically through a decade of fiscal policy and Social Security policy.

2. Budget Outcomes and Projections

Figures 1 and 2 plot the unified federal budget surplus and federal debt held by the public, both expressed as a share of GDP, since the end of World War II. The improvement in federal finances during the 1990s is striking. Early in the decade, federal budget deficits exceeded 4 percent of GDP, and the debt held by the public reached nearly 50 percent of GDP for the first time since the 1950s. By the end of the decade, the budget had recorded its third consecutive unified surplus for the first time since 1947-49, as well as the largest surplus relative to GDP since 1948; debt held by the public had dropped below 35 percent of GDP.

Improved Budget Picture

Table 1 presents key budget data from the past fifteen years. The table shows that the remarkable improvement in the unified budget balance during the 1990s resulted from a significant increase in revenue and a nearly equal decrease in noninterest outlays, both as shares of GDP, together with the resulting impact on interest payments. Tax revenue increased as a share of GDP in part because of tax policy but also because of changing economic conditions; we

return to both of these topics later. Noninterest spending declined as a share of GDP in large part because defense spending fell in nominal dollars and thus dropped sharply relative to GDP.

The federal budget outlook beyond the 1990s also improved sharply during the decade. The CBO's first ten-year projection, published in January 1992, showed large and rising budget deficits in the first years of the 21st century assuming that the law on the books in 1992 was maintained. Further, the CBO's first 75-year budget projection, released in May 1996, showed public debt exceeding GDP by 2020. In contrast, the CBO's ten-year projection in January 2001 showed large and rising budget *surpluses* during the next decade; it also showed the public debt being eliminated (on a net basis) in fiscal year 2009. Moreover, the 75-year projections released in October 2000 showed net public indebtedness below *zero* through 2050. The CBO summarizes its very long-run projections in terms of an estimated "fiscal gap," which is the immediate, permanent tax increase or spending decrease needed to keep public debt below its contemporaneous size relative to GDP for the 75 years following the date of the projection. In May 1996 this gap was 5.4 percent of GDP; by October 2000 the gap had shrunk to 0.8 percent of GDP.

To be sure, some analysts believe that the assumptions underlying these projections are too optimistic. Auerbach and Gale (2000) argue that, over the next decade, discretionary spending is not likely to fall further as a share of GDP and that the number of people affected by the alternative minimum tax (AMT) will not be allowed to increase by a factor of 10 — both of which are implicit in the CBO projections. The CBO itself notes that the fiscal gap could be substantially larger under alternative assumptions about health care costs and long-term productivity growth. That said, for the purpose of assessing the extent of fiscal improvement over

the last several years, the relevant question is whether the assumptions underlying the projections have become more optimistic in the last few years, and if so, by how much. Although it is difficult to judge, we believe that the change in the projections likely provides a reasonable measure of the progress that has been made.²

Sources of Improvement

We explore the timing and sources of the budget improvement in several ways. Figure 3 shows the CBO's surplus and deficit projections in January of 1990, 1993, 1995, 1998, and 2001. As can be seen, the budget picture deteriorated between 1990 and 1993, but improved steadily thereafter.

This improvement stems from a variety of positive developments. The CBO parses the revisions to its projections into the contributions of legislative factors (i.e., policy changes), economic factors (i.e., changes in aggregate economic conditions such as productivity growth and inflation), and technical factors (essentially a residual category showing the total budget change that cannot be attributed to the first two categories). The most important technical factor in the late 1990s was a surge in tax revenue relative to GDP beyond the increase that would be expected given our progressive tax code. The CBO (2000) attributed this surge to a combination of factors: an increase in corporate profits and workers' wages and salaries relative to GDP, an increase in the share of income received by people in the highest tax brackets, and a surge in

² Between January 1998 and January 2001, the CBO increased its estimate of productivity growth during the 10-year budget window by nearly 1 full percentage point. On the other hand, the latest long-run outlook from the CBO also includes a substantial increase in the projected rate of health spending growth.

capital gains from the booming stock market. Indeed, individual income taxes rose from 8.1 percent of GDP in 1995 to 10.2 percent in 2000, even though no significant tax increases were enacted between those years. Another important technical factor during the late 1990s was a sharp deceleration in federal health spending beyond that which was predicted based on changes in Medicare policy.

We present our summary of the CBO's revisions in table 2. We total the revisions between each pair of projection dates shown in figure 3. Each column pertains to a fixed budget window. For example, column 1 shows the cumulative revisions between 1990 and 1993 in surplus projections for fiscal years 1991 through 1995, the 5-year budget window for which projections were released in January 1990. For the other pairs of years, the revisions apply to the ten-year budget window following the first year in that pair; for example, the revisions between 1998 and 2001 apply to fiscal years 1999 through 2008. In order to decompose the revisions into policy, economic, and technical factors, we cumulate the decompositions presented in each of the CBO projections published between the two end points, typically three projections per year.

Before discussing our results, we note four ways in which these calculations likely understate the role of policy actions during the 1990s. First, the most significant policy actions were taken early in the decade when the nominal amounts of revenues and outlays were smaller and the budget window was shorter; this tends to downplay the true importance of these actions compared with the favorable developments later in the decade. Second, because the CBO does not retrospectively re-estimate policy effects, it may have underestimated the role of some specific policy changes in the 1990s. For example, the increase in the top income tax rate in 1993 may have raised more revenue than expected because the CBO considerably

underestimated the share of income that would be received by people in the highest tax brackets.³ And health spending slowed much more sharply after the 1997 reforms than anticipated, perhaps because the reforms had more bite than the CBO realized. Third, the policy actions presumably played a role in improving economic conditions and thereby contributed to the positive economic and technical factors. Fourth, the relative *lack* of policy actions in the face of large and growing surpluses in the late 1990s could be viewed as an active contribution of policy, because the political system had previously aimed simply to balance the unified budget. We return to the third and fourth issues later.⁴

Table 2 presents the results, which we summarize here and discuss in greater detail in our chronology of the decade. During the early 1990s, budget projections deteriorated as the substantial deficit-reduction actions in the Omnibus Budget Reconciliation Act of 1990 (OBRA90) were more than offset by weaker-than-expected economic growth, higher-than-expected federal spending on health programs, and the ballooning cost of dealing with failing thrift institutions. However, the projections in early 1993 represented the nadir. The passage of the Omnibus Budget Reconciliation Act of 1993 (OBRA93) reduced projected budget deficits substantially, and—in contrast with OBRA90—had the good fortune to be followed by several years in which economic and technical factors had little net effect on the budget outlook rather

³ Of course, people who faced higher tax rates after 1993 might have reported even higher income in the absence of the policy change. Feldstein (this volume) elaborates on this point.

⁴ It is worth emphasizing that the CBO’s “no-policy change” baseline projections assume that discretionary spending grows with inflation and therefore shrinks over time relative to GDP. Under a baseline that assumed that discretionary spending would remain constant relative to GDP, the policy category would receive credit for the fact that discretionary spending declined relative to GDP over this decade.

than causing it to deteriorate substantially.⁵ Even so, in January 1995, the CBO was still projecting rising deficits under current law. Three years later, the outlook was much better: the beneficial effects of the Balanced Budget Act of 1997 (BBA97) and other policies, coupled with very large gains in both economic and technical factors, produced a forecast of imminent surpluses. By January 2001, the budget picture had again improved dramatically, owing to positive economic and technical revisions of an astounding magnitude. Policy actions in the late 1990s were scored as reducing projected surpluses; the most prominent of these actions was the sharp increase in late 2000 in the discretionary spending caps. However, the CBO tally does not incorporate the effects of President Clinton’s “Save Social Security First” strategy (discussed below) which arguably allowed hundreds of billions and perhaps trillions of dollars of surpluses to flow through to pay down debt, rather than being used for additional spending or tax cuts.

A final perspective on the improving fiscal situation during the 1990s is provided by figure 4. This figure decomposes the difference between the CBO’s January 1993 projection and the actual outcome (or the 2001 projection for the years beyond 2000). Thus, whereas table 2 cumulated revisions between several pairs of projection dates, figure 4 shows cumulative revisions relative to a single projection date, 1993. During the years around the turn of the century, policy changes contributed about one-quarter of the total improvement, with the rest nearly evenly split between economic and technical factors. Over the entire period between 1994 and 2000, actual outcomes were roughly \$2.6 trillion better than the CBO’s 1993

⁵ According to the CBO, OBRA93 reduced projected budget deficits by more than \$400 billion over five years and by more than \$1500 billion over ten years. The former figure was central in the political discourse of the time, but the latter figure is consistent with the current focus on ten-year budget windows and therefore is shown in our table.

projection—and policy changes accounted for one-third of this improvement. Moreover, as discussed earlier, this estimate should be seen as a lower bound on the true contribution of policy, in part because it omits all contributions from potential surplus-dissipating actions not taken.

In sum, the remarkable improvement in the budget outlook during the 1990s can be attributed in substantial part to policy actions taken and avoided. But it also occurred in important measure because of an economic boom that surpassed expectations, higher tax revenue than would have been anticipated given overall economic conditions, and slower-than-expected growth in health costs. We turn now to a chronological review of developments in budget and Social Security policy during the decade.

3. Budget Deficit Reduction: 1990 through 1997

In 1985, rising concern about large federal budget deficits led to passage of the Gramm-Rudman-Hollings deficit-reduction law, which set explicit annual deficit targets that declined to zero over several years. When the target proved too difficult to meet in 1987, the targets were raised. Thus, when the 1990s began, the size of federal deficits—and the apparent inability of the political process to reduce them—were central features of the political landscape.

OBRA90

In the spring and summer of 1990, President Bush and the Congress debated and negotiated alternative routes to deficit reduction. These initial discussions were inconclusive, despite the President's expressed willingness to increase taxes as part of a broader budget

package (which ran counter to the view expressed by many Republicans). However, the Iraqi invasion of Kuwait and deteriorating economic conditions seemed to provide additional impetus to the desire to “put our fiscal house in order,” and President Bush and the Congressional leadership announced a budget agreement on October 1st. Yet, the House of Representatives voted down the plan by a wide margin four days later, again throwing the budget picture into disarray. Indeed, this initial failure of the long-term budget deal created a short-term problem as well: a temporary appropriations bill lapsed, shutting down most of the government for a long weekend. In late October, Treasury Secretary Nicholas Brady stated that President Bush was open to a rate increase on upper-income taxpayers. Several days later, the Congress approved an altered plan for deficit reduction as OBRA90.

According to the CBO’s projections, OBRA90 reduced the deficit by nearly \$500 billion over five years compared with then-current law. This accomplishment had an important effect on the fiscal outcomes of the 1990s and on the fiscal situation faced by the incoming Clinton administration several years later. In two key respects, the plan represented an approach to deficit reduction that differed significantly from that used in the late 1980s and that became a model for fiscal constraints in the 1990s. First, the plan included a set of specific actions to reduce the deficit, rather than a set of deficit targets. This new approach did not require incremental fiscal stringency in response to a slowing economy. This was important because it preserved the functioning of the automatic stabilizers, and it avoided forcing the Congress to tighten the budget precisely when doing so would be most politically painful.

Second, the plan introduced a new set of budget enforcement rules designed to deter legislative actions that would worsen the deficit. One rule was a “pay-as-you-go,” or “paygo,”

constraint on taxes and entitlement spending: any tax cut and any increase in entitlement spending would need to be offset by an equal amount of tax increase or entitlement spending reduction. Another aspect of the enforcement system was “caps,” or limits, on discretionary spending over the following several years. The caps were set so that they increased by less than expected inflation, thereby squeezing down real discretionary spending over time. Because discretionary spending is ultimately determined in annual appropriations bills, this approach allowed policymakers to defer some difficult deficit-reduction decisions; nevertheless, the caps were adhered to for a time, and in combination with the prevailing determination to shore up the nation’s fiscal foundations, likely contributed to the improvement in the budget situation.

OBRA93

During his campaign for the Presidency, Bill Clinton argued that America needed to tackle both the budget deficit and the “public investment deficit.” His economic plan *Putting People First* explained:

“Our strategy puts people first by investing more than \$50 billion each year over the next four years to put America back to work—the most dramatic economic growth program since the Second World War. Our strategy recognizes that the only way to lay the foundation for renewed American prosperity is to spur both public and private investment. To reclaim our future, we must strive to close both the budget deficit and the investment gap. . . . To pay for these investments and reduce our national debt, we will save nearly \$300 billion by cutting spending, closing tax loopholes, and requiring the very wealthy to pay their fair share of taxes. Our plan will cut the deficit in half within four years and assure that it continues to fall each year after that” -- *Putting People First* (page 7)

This plan ultimately evolved into OBRA93.

The First Clinton Budget

In February 1993, the Clinton administration put forward its first budget document, “A Vision of Change for America.” President Clinton enunciated his economic strategy this way:

“My plan has three key elements: economic stimulus to create jobs now while laying the foundation for long-term economic growth; long-term public investments to increase the productivity of our people and businesses; and a serious, fair, and balanced deficit-reduction plan to stop the government from draining the private investments that generate jobs and increase incomes.” -- *A Vision of Change* cover letter

The administration described its budget over five years as follows: First, the budget included \$328 billion of revenue increases, \$329 billion of non-interest spending cuts, and \$46 billion of reduced debt service, for “gross deficit reduction” of \$704 billion. The tax increases included a new top income tax bracket, removal of the wage cap for Medicare taxes, and a broad-based energy tax based on the energy content (measured in BTUs) of fuel consumed. The spending reductions included cuts in Medicare provider reimbursements, defense spending, and a range of nondefense discretionary spending, along with an extension of the discretionary spending caps and paygo rules of OBRA90. Second, the budget proposal included \$144 billion of additional “investment outlays,” which we discuss shortly. Third, the plan had \$77 billion of “tax incentives,” including a significant expansion of the Earned Income Tax Credit. Lastly, the plan had about \$15 billion of “stimulus outlays.” Overall, therefore, the plan was projected to provide nearly \$500 billion of net deficit reduction.⁶

Woodward (1994) and Reich (1997) provide accounts of the behind-the-scenes development of the Clinton budget. Both sources emphasize the ongoing conflict between the

⁶ In fact, about half of the stimulus outlays were scheduled to occur during fiscal year 1993, which was already underway and which preceded the 5-year budget window.

desire for deficit reduction and the desire to provide both short-term economic stimulus and long-term public investments. We turn to these issues now.

Deficit Reduction and Economic Stimulus

Traditional economic analysis of deficit reduction implies that reducing government spending or increasing taxes depresses economic activity in the short run but by raising saving and investment boosts productivity and the overall productive capacity of the economy down the road. However, an alternative view of the short-run effect of deficit reduction was developed in the 1980s by Blanchard (1984) and Branson (1985) among others. The idea is straightforward: an expectation of lower future deficits reduces *future short-term* interest rates, and these lower future short-term rates generate lower *current long-term* interest rates. Lower long-term interest rates could stimulate business investment and other interest-sensitive spending immediately, offsetting at least some part of the direct contractionary effect of deficit reduction. The net effect on short-run output depends in part on the size of the reduction in the current deficit compared with the expected reduction in the future deficit. Indeed, the 1984 *Economic Report of the President* (pages 40 and 41) invoked this line of reasoning a decade earlier in arguing that a credible phased-in deficit reduction plan would not hamper economic growth even in the short run. This argument is basically the standard “crowding out” view of fiscal policy run in reverse: greater fiscal restraint should lower interest rates and thereby “crowd in” private activity. The novel twist is that the stimulus from the lower interest rates might be elicited even before the contractionary impact of actual cuts in spending or increases in taxes had been felt.

Yet as of 1993, this theory was largely untested, and President Clinton received differing advice about its likely importance. Some members of the economic team believed that long-term interest rates were unusually high because of expectations about the federal deficit, and that altering those expectations would bring down long-term rates and thereby stimulate economic growth. Others argued, however, that reducing the deficit would likely slow the economy and “cost jobs” in the short run, although it would increase private investment and productivity over time. While these advisers acknowledged the possibility that a decline in long-term interest rates would cushion the economy from some of the direct contractionary effect of deficit reduction, they tended to view a full offset as a long shot. The uncertainty about the short-run effect of deficit reduction continued throughout the year. A July 15th memo to the President from the Council of Economic Advisers reportedly noted that the economy was weaker than had been anticipated and that the budget plan then working its way through Congress was more contractionary in direct terms than the President’s original proposal. Nonetheless, the administration retained its public commitment to deficit reduction.

Public Investments

A key element of President Clinton’s campaign platform was targeted increases in public spending. The detailed description of the economic plan referred to a significant increase in infrastructure investment, the creation of a civilian research and development agency to encourage conversion of a “defense-based economy to a peacetime one,” a nationwide network of community development banks, additional police officers, “empowering those on welfare by providing education, training and child care,” fully funding the Head Start and Women, Infants

and Children (WIC) programs, a Youth Opportunity Corps, greater availability of subsidized college loans, and guaranteed health benefits for all Americans. Indeed, the first Clinton budget stated: “Deficit reduction at the expense of public investment has been and will continue to be self-defeating. The Clinton plan is explicitly and emphatically aimed at reducing the deficit while increasing much-needed public investment” (page 10).

Nevertheless, increasing these outlays was clearly at odds with the objective of reducing the budget deficit, and the deterioration in deficit projections in late 1992 heightened this conflict. While the President’s economic team was united in believing that both public investments and deficit reduction were important, different members of the team put different weights on the two objectives. Moreover, the President’s political advisers were said to be generally quite critical of the focus on deficit reduction, viewing the proposed outlays as the objectives over which they had fought the election.

In the end, the additional outlays proposed during the campaign were whittled down very substantially. The President was reported to have been torn — determined to rectify a perceived deficit in public investment in both physical and human capital, but also believing that the best way to gain the ability to address that agenda was to first get control of the fiscal situation. And Robert Rubin (then Director of the National Economic Council and later Treasury Secretary) said near the end of the administration that President Clinton had understood the potential stimulative effects of lower budget deficits and lower interest rates: “Clinton said, ‘I have a jobs program, and my jobs program is deficit reduction’” (*New York Times*, 12/25/00). Ultimately, the President’s budget included only part of the new outlays proposed during the campaign, and only a fraction of that amount was contained in the final legislation. In particular, while new funding

was provided for the Earned Income Tax Credit, Head Start, and WIC, the proposed infrastructure spending was largely abandoned,.

Passage of OBRA93

President Clinton presented his budget in mid-February. Several days later, Alan Greenspan testified before the Senate Banking Committee, commenting that “the President is to be commended for placing on the table for debate” a “serious” and “plausible” economic plan. Newspaper stories interpreted Greenspan’s remarks as essentially endorsing Clinton’s overall strategy while staying removed from the specifics.

About one month later, the House of Representatives approved a budget resolution based on the framework of the administration’s deficit-reduction plan, though as noted above the resolution included only a fraction of the public investments that Clinton had proposed. Separately, the House then passed the stimulus package as well. The Senate followed by passing a budget resolution that was similar to the House’s, but balked at the stimulus package. After an extended filibuster, Clinton announced in mid-April that he would withdraw the stimulus package.⁷ Shortly thereafter, the proposed BTU tax also ran into heavy resistance, especially in the critical Senate Finance Committee. In early June, Treasury Secretary Lloyd Bentsen said publicly that there would not be a BTU tax.

The House and Senate passed separate budget plans by very narrow margins in May and June, but the outcome of the conference process was still very uncertain. Finally, in August, the

⁷ A \$4 billion bill extending unemployment compensation, which had been part of the stimulus package, was passed separately.

House approved a deficit-reduction plan by a 218-to-216 vote, with all Republican members voting against and nearly all Democrats voting in favor. The next day, the Senate passed the bill, on a vote of 50-50, again with all Republicans voting against, and with Vice President Al Gore casting the tie-breaking vote in favor of passage. President Clinton signed this bill into law as OBRA93.

What Did Deficit Reduction Ultimately Accomplish?

Throughout the debate on OBRA93, sharply differing views were expressed about the economic implications of the package. A number of the harshest critics prophesied that a recession would surely result if the budget framework were enacted. As it turned out, economic growth accelerated in 1994, and the second half of the 1990s witnessed an extraordinary economic boom. What role did deficit reduction play in this success story? That is inherently a difficult question to answer, but we believe that the fiscal discipline launched by OBRA90 and OBRA93 made an important contribution to the 1990s economic expansion.⁸

Most notably, the expansion was characterized by a remarkable surge in investment, especially in business equipment and software. Between 1990 and 2000, outlays in this category increased at an average annual rate of more than 10 percent in real terms. Several factors likely contributed to this explosion, including strong output growth, robust profits, and rapid technological progress. But investment was also supported by the sharp reduction in federal government deficits that left more resources available for private use. Indeed, we think it likely

⁸ See Blinder and Yellen (2001) and Rubin (this volume) for endorsements of this view.

that both technical advances and greater national saving were necessary for the investment boom that the country enjoyed, and that neither alone would have been sufficient.

Figure 5 shows net national saving (that is, total saving less capital depreciation) and its components as shares of GDP during the past 20 years. The turnaround in the federal budget caused saving to be about 7 percent of GDP higher than it would have been if deficits had remained at their 1992 level. Between 1992 and 1997, a decline in saving by households, businesses and state and local governments offset some of the rise in federal saving, but national saving still increased by almost 3 percent of GDP. After 1997, a sharp drop in non-federal saving more than offset the continued increase in federal saving, and national saving declined. Although a Ricardian might view the decline in private saving as a response to the additional federal saving, the consensus view attributes that decline primarily to the dramatic runup in stock prices.

An alternative indication of the effect of deficit reduction can be gleaned from the path of interest rates over the course of 1993. Interest rates reflect the balance of supply and demand in the market for loanable funds. A reasonable presumption is that the private demand for funds was, if anything, increasing over the course of 1993 as the economic recovery gathered strength. Even so, market interest rates declined during 1993, suggesting that the net supply of funds (after federal government demands had been satisfied) must have been seen as increasing. Moreover, the day-to-day timing of the decline in interest rates aligns well with news about the prospects for passage of OBRA93 (see the discussion in the 1994 *Economic Report of the President*).

The significant increase in the nation's capital stock generated by the investment boom of the 1990s benefited the economy in several ways. First, it helped to raise productivity: labor

productivity increased nearly twice as fast between 1995 and 2000 as between 1975 and 1995. Second, it helped contain inflation: the rate of change in the price index for personal consumption expenditures excluding food and energy drifted downward through most of the decade, even as the strength of the economic expansion increased.

The improvement in the federal budget balance did *not* end the large deficits in international trade that the United States began to run during the 1980s. At that time, popular discourse linked the burgeoning budget and trade deficits together as the “twin deficits,” and not without reason: as a matter of arithmetic, domestic investment must be financed either by domestic saving or foreign saving. Therefore, assuming no change in domestic investment, a decline in domestic saving resulting from a larger government deficit must be offset by more foreign saving. But foreigners save by exporting more goods and services to us than we send to them – in other words, by causing us to run a larger trade deficit. Thus, the popular moniker of “twin deficits” was valid as far as it went, but it failed to account for changes in domestic investment. And, as we have noted, one of the most dramatic developments in the 1990s was a surge in domestic investment, to such an extent as to overwhelm the increase in domestic saving and require an increase in the supply of funds from abroad.

The Republican-Controlled Congress

The most prominent federal policy issue between the fall of 1993 and the fall of 1994 was the Clinton administration’s proposal for national health care reform. This proposal is discussed at length by Cutler and Gruber (this volume). Here we simply note that one concern about the administration plan—both inside and outside the administration—was its likely effect on the

budget deficit. Indeed, when the CBO released its analysis of the administration proposal, it estimated that the proposal would, on balance, increase the deficit. No comprehensive health-care reform plan passed the Congress in 1994.

Then, in the 1994 election, Republicans won majorities in both the Senate and the House of Representatives. The Republican leadership said that it had a mandate for a multi-part platform known as the “Contract with America.” The planks in this platform called for large tax cuts, line-item veto power for the President, a constitutional amendment requiring a balanced federal budget, and the elimination of the budget deficit by 2002.

In 1995, Congressional Republicans tried to implement these policies. The House approved a balanced-budget amendment in January — by nearly a 3-to-1 margin — but the Senate rejected the amendment in March, as support fell just short of the two-thirds majority needed. The House and Senate also approved line-item veto legislation that would have given presidents the ability to reject individual items in spending bills without vetoing entire bills. Although Clinton signed the legislation into law, the Supreme Court struck down the law as an unconstitutional delegation of Congressional authority to the executive branch. Both houses of Congress also passed bills cutting spending by \$16 billion in the fiscal year then under way. And both houses passed budget resolutions in May laying out broad frameworks for balancing the budget by 2002.

The Clinton administration responded to the Contract with America in part by trying to occupy the political center. Thus, the administration’s budget included small middle-class tax cuts as well as various spending cuts that, taken together, provided a small net reduction in projected budget deficits. President Clinton attacked the balanced budget amendment and

charged that the Republicans' proposed "deep cuts in federal spending amount to war on children" (*New York Times*, February 25, 1995, page 1). He cast his first veto as president to reject the legislated cuts in current-year spending, although he later approved a revised package of cuts totaling the same amount. Then, in June, Clinton outlined a plan to balance the budget by 2005. By achieving balance more gradually than the Republicans, using the more optimistic projections of the Office of Management and Budget rather than the CBO, and including smaller tax cuts than the Republicans, the administration reduced the scale of the required spending reductions. In particular, the administration emphasized that the Republican plan would have entailed much larger cuts in Medicare and Medicaid than the administration's plan.

As budget negotiations stretched into the fall, Congressional Republicans tried to force the administration to accept their budget framework using two different strategies. One strategy was based on appropriations bills, and it resulted in two government shutdowns. By mid-November, only three of the thirteen appropriations bills for the fiscal year already under way had been passed. The continuing resolution (CR) that was funding the agencies not covered by those three bills was expiring, and the Republicans refused to pass a further CR without concessions on the overall budget plan that the administration refused to make. All "non-essential" workers in those agencies were then furloughed for six days, until President Clinton accepted the Republicans' goal of balancing the budget in seven years and the Congress approved another CR. Yet, negotiations broke down again by mid-December, and most of the federal government was shuttered for another three weeks. Eventually, the Republicans abandoned this strategy in January 1996.

The Congressional Republicans' second strategy, pursued simultaneously with the appropriations battle, was based on the statutory limit on federal debt. The government was on track to exceed the debt limit by November; doing so would have caused the government to default for the first time in history, because it would have been unable to borrow sufficient funds to meet its obligations. The administration defeated this strategy by taking a variety of complex steps to keep the officially measured debt below the statutory limit while still carrying on the government's activities. In mid-November, Treasury Secretary Rubin ordered the suspension of new investments for the federal employees' defined-contribution retirement plan and the early redemption of some bonds held by the civil service defined-benefit retirement fund. In mid-February, with the impasse over the debt limit still continuing, Rubin suspended investment of Treasury's Exchange Stabilization Fund, redeemed additional securities prior to maturity from the civil service retirement fund, and authorized a set of asset exchanges among a government trust fund, a government corporation, and the Treasury. Some members of Congress criticized these actions, and Representative Gerald Solomon called for Rubin's impeachment. In the end, default was avoided, the debt limit was finally increased in March 1996, and the assets of these various funds were restored to what they would have been absent these maneuvers.

By April 1996, President Clinton and the Congress essentially agreed to disagree: they passed a modest budget package that funded the government at close to current-law levels and made small changes in tax policy. Many observers believed that President Clinton had won the battle over the shutdown and had staked out the political center as a fiscally disciplined moderate.

According to projections available in early 1997, deficits under then-current law would persist and eventually increase again, despite the sharp improvement in the fiscal outlook during the preceding several years. In February 1997, the administration put forward a budget designed to achieve balance in five years. Negotiations between the administration and Congress stalled until mid-March, when House Speaker Newt Gingrich expressed his willingness to scale back Republican tax-cut plans. Budget talks resumed in early April, and a deal had nearly been reached on an overall budget framework by May 1. Then the CBO told the administration and Congressional leadership that it was reducing its projection of budget deficits over the following five years by \$225 billion. Taking advantage of that last-minute windfall, negotiators announced the outline of an agreement the next day. Filling in the details of that outline proved to be a contentious undertaking. After two weeks of haggling, a complete budget deal was announced on May 15. But passing the specific bills needed to implement that deal involved further sparring and, eventually, compromise. At the end of July, the Taxpayer Relief and Balanced Budget Acts of 1997 passed by wide margins in both the House and Senate, and were signed into law by President Clinton in early August.

The CBO estimated that this legislation would produce much less deficit reduction than OBRA90 or OBRA93, but would lead to a balanced unified budget in 2002. Outlays were trimmed by nearly \$200 billion over the following five years, including a reduction in payments to Medicare providers and a modification and extension of the discretionary spending caps. But taxes were cut by about \$80 billion over the five-year period, including several new tax credits favored by the administration and a cut in the capital gains tax rate favored by Republicans. In

retrospect, this law may have trimmed outlays by more than the CBO anticipated, because Medicare spending fell well below CBO projections in subsequent years.⁹

4. Entitlement Reform and Saving Social Security First

Throughout the 1990s, many institutions, analysts, and commissions sounded the alarm about longer-term fiscal issues. The annual reports of the Social Security and Medicare Trustees projected that both systems were significantly out of actuarial balance, and would eventually require reform; new long-run budget models from OMB and CBO predicted exploding levels of debt after 2010; and generational accounts calculated both inside and outside the government showed large tax burdens on future generations. For example, the Social Security Trustees projected in 1997 (Board of Trustees, 1997) that Social Security outlays would rise from 11 percent of payroll in 1997 to 20 percent of payroll in 2075, requiring a 50 percent increase in the payroll tax if no other changes were made. At the same time, the CBO projected that total government expenditures would exceed revenues by as much as 17 percent of GDP in 2030 and that public debt would reach 100 percent of GDP in 2030.¹⁰ Generational accounts published in

⁹ More than half of the five-year reduction in outlays was scheduled to occur in FY 2002, the target date for deficit elimination. Moreover, the net tax cut in FY 2002 was only about half of the net tax cut in either FY2001 or FY2003, owing to shifts in the timing of tax obligations.

¹⁰ CBO (1997) presents deficit projections for 2030 that range from 8 percent to 17 percent of GDP. The lower estimate assumes that discretionary spending grows at the rate of inflation, and therefore shrinks substantially as a share of GDP, and that there is no economic feedback between the budget deficit and other economic variables. The higher estimate assumes that discretionary spending remains constant as a share of GDP, and that—by soaking up national saving that otherwise would have been available for investment in productive plant and equipment—the deficit reduces economic growth.

the 1993 federal budget suggested that lifetime net tax rates would have to rise from 34 percent to 71 percent to sustain then-current fiscal policies.¹¹

The primary causes of these projected long-term imbalances were—and continue to be—rising medical costs and the aging of the population. Declining fertility and rising life expectancy imply that the ratio of workers to beneficiaries will fall from 3:1 to 2:1 between 2000 and 2030 (Board of Trustees, 2001). Because longevity gains and low fertility rates are expected to persist, this is not simply a temporary phenomenon associated with the retirement of the baby boom generation, but rather the leading edge of a new plateau. Moreover, spending on medical care is projected to rise faster than GDP for decades to come due both to population aging and to the adoption of new medical technology.

Entitlement Commissions

Three important commissions on entitlement reform during the 1990s considered changes in Social Security: the Bipartisan Commission on Entitlement and Tax Reform co-chaired by Senators Bob Kerrey and John Danforth, the 1994-1996 Advisory Council on Social Security chaired by Edward Gramlich, and the 1997-1998 National Commission on Retirement Policy co-chaired by Senators John Breaux and Judd Gregg and Congressmen Jim Kolbe and Charles Stenholm.

Kerrey-Danforth

¹¹ See Auerbach, Gokhale and Kotlikoff (1994) for a description of these estimates.

In order to secure Senator Kerrey's decisive vote for the 1993 budget agreement, President Clinton agreed to create a commission on entitlement reform and appoint the Senator as chairman. The commission set for itself the goal of developing a package of revenue and spending measures that would bring Social Security into long-run balance and hold the unified budget deficit at its 1995 level relative to GDP in the long run. In December 1994, the commission issued a staff report summarizing entitlement and tax reform options. The Social Security options included raising the age of eligibility for full benefits, reducing cost-of-living adjustments and spouses' benefits, subjecting more benefits to taxation, and diverting a portion of the Social Security payroll tax into mandatory private retirement accounts. Not all of these options would have been required to bring the system into balance, but they are representative of the approaches that were generally under consideration at the time. The Medicare options included imposing a new monthly premium for beneficiaries and increasing the deductible from \$100 to as much as \$1200. The options on the revenue side included eliminating deductions for state and local taxes and for charitable contributions.

A majority of commission members voted against the proposals ultimately put forth by Senators Kerrey and Danforth (Bipartisan Commission, 1995), and Congressional leaders and administration officials distanced themselves from the commission's findings. For example, incoming House Speaker Newt Gingrich responded to the proposals by saying "I think Social Security is off the table for the foreseeable future. We have so many other more pressing and more immediate problems and we ought to focus on the ones that are immediate, not the ones that are 20 years out" (*Washington Post*, December 12, 1994, page A8). White House Chief of Staff Leon Panetta stated that the administration was opposed to any proposal for reducing Social

Security spending (*Washington Post*, December 15, 1995, page A18). Nonetheless, Senator Kerrey and commission member Senator Alan Simpson went on to introduce Social Security reform legislation based on the commission's work.¹² The Kerrey-Simpson bills gradually raised the early retirement age from 62 to 65 and the age of eligibility for full benefits to 70, reduced cost of living adjustments for Social Security, and shrank benefits for spouses. The legislation also permitted 25 percent of the Social Security trust fund to be invested in private-sector stocks and bonds, and gave workers the option of diverting 2 percentage points of their payroll tax payments to individual investment accounts in exchange for lower Social Security benefits.

Social Security Advisory Council

Secretary of Health and Human Services Donna Shalala appointed the second major commission, the 1994-1996 Advisory Council on Social Security, in response to a legal requirement that an advisory council be empaneled every four years to review the Trustees' estimates and comment on relevant policy issues.¹³ This particular advisory council was given an usually broad mandate and charged with reviewing Social Security's long-run financing, the equity and adequacy of benefits, and the relative roles of the public and private sectors in the provision of retirement income. The 13-member committee was chaired by Edward Gramlich and followed the traditional practice of including three representatives from organized labor,

¹² Senator Danforth retired from the Senate at the end of 1994.

¹³ By tradition, the quadrennial advisory councils in turn sponsored technical review panels that examined the assumptions and methods underlying the Trustees' estimates of actuarial imbalance. The 1994 legislation making Social Security an independent agency eliminated the quadrennial advisory councils and replaced them with a more permanent advisory board.

three representatives from the employer community, and other experts. The council intended to complete its work by the end of 1995, but the breadth of its mandate and the contentious nature of its discussions led it to delay its final report until January 1997.¹⁴

The members of the advisory council came to consensus on three key issues.¹⁵ First, there should be substantially more advance funding of Social Security's long term obligations in order to boost national saving. Second, equity investments should play an important part in Social Security reform. And third, reform should not only meet the traditional goal of bringing the system into 75-year balance, but also leave the ratio of the trust fund to annual benefits stable at the end of the 75-year period. However, council members disagreed quite strongly about the way in which these changes should be implemented, splitting into three factions with different recommended solutions for Social Security's long-run financing problem.

Six of the thirteen council members, led by former Social Security Commissioner Robert Ball, favored a plan that aimed to preserve the present Social Security benefit structure as much as possible. The key feature of this plan was investing 40 percent of the Social Security trust fund in equities instead of the special Treasury bonds traditionally held by the trust fund. Because equities are projected to earn a higher expected return than bonds, this change in the trust fund's portfolio would be scored as achieving 75-year solvency with relatively small

¹⁴ Schieber and Shoven (1999) provide a fascinating account of these discussions.

¹⁵ In addition to the issues we highlight, the advisory council also reached a consensus on restructuring Social Security family benefits, extending mandatory coverage to all state and local government workers, extending the period over which the indexed annual wage is computed, accelerating the increase in the age of eligibility for full retirement benefits, and revising the income taxation of Social Security benefits. See 1994-1996 Advisory Council (1997) for details.

changes in revenues and benefits.¹⁶ To prevent the system from ultimately drifting out of balance, the plan also proposed raising the payroll tax by 1.6 percentage points beginning in 2045.

Two members, led by council chairman Gramlich, proposed adding individual accounts on top of the existing Social Security system. In contrast with the Kerrey-Simpson individual account proposal, this plan maintained the entire 12.4 percent payroll tax for the traditional defined-benefit program, which meant that its benefit cuts did not have to be as deep. The individual accounts were to be funded by mandatory additional contributions of 1.6 percent of covered payroll, which it was hoped would represent additional national saving. Individuals would choose how to allocate their account balances among a limited number of equity and bond index funds.¹⁷

Five council members, led by Sylvester Schieber and Carolyn Weaver, proposed much larger individual accounts. They suggested that 5 percentage points of the payroll tax be diverted to individual accounts; another 5 percentage points would provide a flat benefit to all retirees at about two-thirds of the poverty line; and the remaining 2.4 percentage points would be used to continue survivor's and disability insurance. Additional tax revenue equal to 1.5 percent of payroll for the next 75 years would be needed to fund the transition to this system.

¹⁶ In the final report, the supporters of this plan did not actually recommend equity investments. Instead, they wrote that the plan “envisions, after a period of study and evaluation, the possibility of large-scale investment of [Social Security trust fund] monies in the equity market in order to help bring the program into balance.” There was no recommendation for eliminating the actuarial imbalance if equity investments were not ultimately pursued.

¹⁷ Gramlich (1998) explains the reasoning behind this plan.

The Gramlich Commission struggled to reach consensus around a single plan, but eventually published a final report that reflected these three starkly different visions of Social Security reform. Ironically, the commission may have been considerably more valuable for not having reached consensus, because its analysis of these three alternatives served as a valuable launching pad for future analysis, including the work of Clinton administration staff.¹⁸ It is also worth noting that, despite the divisions on the commission, the majority of members supported some sort of individual accounts as part of Social Security. Thus, the idea of individual accounts had, in a few short years, made a remarkable transition from the white papers of libertarian think tanks to the mainstream policy debate.

Breaux-Gregg-Kolbe-Stenholm

Unlike the first two commissions, the Center for Strategic and International Studies' National Commission on Retirement Policy was not government-sponsored, although its co-chairs Senators Breaux and Gregg and Congressmen Kolbe and Stenholm were committed to introducing the commission's ultimate recommendations in legislation. The group was launched in January 1997 and released its proposal in May 1998. It recommended diverting 2 percentage points of the payroll tax to create individual accounts. To rectify the imbalance in the traditional system (made even deeper by the carve-out of tax revenue), the plan raised both the normal and early retirement ages, assumed that further cost-reducing changes would be made to the

¹⁸ Another reason why the report was so valuable was that it incorporated a great deal of analytical material developed under the direction of Harry Ballantyne and Steve Goss, Chief Actuary and Deputy Chief Actuary, respectively, at the Social Security Administration, as well as by the members of the technical review panels.

consumer price index, and reduced benefit levels by altering the formula that translates lifetime earnings into benefits. In order to shield low-income households from some of the benefit cuts, the plan introduced a new minimum benefit for workers with at least 20 years of earnings. This benefit increased from 60 percent to 100 percent of the poverty line as a worker's years of earnings increased from 20 to 40, so a household headed by a worker with 40 years of earnings would never fall below the poverty line.

Despite the persistent belief during this period that current fiscal policy was not sustainable in the long run, none of these proposals came close to being enacted. Quite understandably, the need to reform a system that was projected to remain solvent for at least another 30 years to second place on the political agenda to the urgency of addressing the near-term fiscal deficits.¹⁹

Social Security

Within the White House, serious consideration of tackling long-run entitlement issues began in the middle of 1997. During the preparations for his second inaugural address, President Clinton had told his advisers that he wanted to make strengthening Social Security one of his top goals for his second term. In addition, Congress was insisting on creating a Medicare commission as part of the 1997 budget agreement, and the administration needed to decide how to respond. Most important, the administration realized that its next budget projections would

¹⁹ The other important piece of Social Security legislation during this period was introduced by Senator Moynihan. It proposed to cut the payroll tax and gave workers the option of using the tax savings to fund an individual account, in which case their contribution would be matched by the employer share as well. The plan also included various benefits cuts and, in the long run, increased the payroll tax to 13.4 percent of payroll.

include substantial unified surpluses between 2002 and 2007. Because these surpluses would fall within the ten-year budget window, the administration would need to propose a policy for allocating them.

This imminent end to the era of deficits was viewed by the administration as creating both opportunities and dangers. On one hand, the availability of surpluses gave the administration the freedom to contemplate new ambitious goals. On the other hand, President Clinton had successfully headed off Republican calls for deep tax cuts during the previous five years by calling for fiscal responsibility and deficit reduction. In an era of surpluses, it was harder to see what strategy would be more popular than Republican tax cuts, which were viewed by the administration as likely to have adverse distributional consequences and to reduce national saving at a time when the country should be saving more to prepare for the retirement of the baby-boom generation.

Political Pressures

The administration's economic team met throughout the summer and fall of 1997 to consider tax reform options, strategies for the new surplus era, and entitlement reform. Although these meetings initially were conducted on separate tracks, it was realized eventually that these topics were closely related, and the three topics were merged into a single set of "special issues" meetings that focused on ways to use the projected surpluses.

At an early point in this process, the President's health advisers argued that fundamental Medicare reform should not be pursued aggressively. These advisers believed that the combination of population aging and rising health costs per beneficiary made Medicare's long-

term financing problems too large to resolve at that time. They also felt that the 1997 budget agreement already embodied many of the steps that the administration was ready to embrace with respect to Medicare reform.

Fundamental tax reform was also viewed as having substantial political and economic risks. First, if the President opened the door to a major tax bill, the administration might well lose control of the process to Congress. Then, a flat-tax plan with significant revenue loss (and therefore a negative effect on national saving) and adverse distributional consequences could have become the focus of the debate. Second, any reform that simplified the tax code or encouraged saving to a significant degree would likely create millions of losers as well as millions of winners, even with the commitment of substantial surplus funds. Lastly, no particular tax reform proposal ever gathered momentum among the economic team.

In contrast, there was considerable enthusiasm among the economic team for undertaking Social Security reform. This enthusiasm stemmed in part from the plausible reform alternatives laid out by the Gramlich Commission and in part from the Rooseveltian legacy for the President that would come from putting Social Security on secure ground for the coming century. But the President's advisers also believed that proposing to use the surpluses for Social Security reform was more likely than the other alternatives to block both tax cuts and new spending. Thus reforming Social Security could do double duty – helping to solidify the improving budget outlook—President Clinton's most important economic accomplishment—by permitting the projected surpluses to feed through to national saving, and facilitating the rejuvenation of the nation's most important social program. Indeed, the economic team believed that even in the

likely event that the reform effort failed, the debate over Social Security reform would be healthy in and of itself, and could go a long way toward maintaining fiscal discipline.

The administration's economic team was also aware of a significant group within the Democratic Party that downplayed the need for Social Security reform, partly in order to prevent radical change in the program. This group emphasized that, under the Social Security Trustees' low-cost assumptions, the system remains solvent throughout the 75-year projection period. Given this possibility that the existing system might be viable, why open the Pandora's box of "reforming" the crown jewel of American social programs? The administration's economists gave less weight to this argument for two reasons. First, the low-cost projections assume that a large number of factors such as fertility growth, mortality rates, immigration, and economic growth all turn out much better than expected—which presumably has very low probability. Second, recent research by academic demographers (for example, Lee and Tuljapurkar, 1998) suggests that longevity would likely increase more rapidly than projected by the Social Security Trustees, which would raise the costs of the program. Thus, the distribution of possible outcomes seemed weighted toward a worse, not a better, financial situation than projected by the Trustees.

In a similar way, some observers noted that the Social Security Trustees' assumption of 1.6 percent annual GDP growth in the long run was far below the 3.1 percent annual average growth experienced in the last 30 years, and argued accordingly that the Trustees were being much too pessimistic about growth.²⁰ This argument missed the point that the growth of the labor force is projected to slow from its current pace of about 1 percent per year to approximately

²⁰ The numbers in this paragraph are taken from the 2001 Trustees' Report.

zero when the baby-boom generation begins retiring in earnest. GDP growth can be decomposed into the sum of the growth of the labor force (the number of workers) and the growth of productivity (output per worker). The Social Security Trustees are assuming that productivity growth in the long run will roughly match its 1.5 percent annual historical average. With the growth of the labor force dropping to about zero, productivity growth would have to roughly double from its historical average rate in order for GDP growth to be maintained at its historical average pace. Moreover, faster economic growth has limited ability to improve Social Security's finances in the long run because a retiree's initial level of Social Security benefits is indexed to aggregate wage growth during his or her working years. It is only because benefits after retirement are indexed to inflation rather than wages that economic growth improves the actuarial standing of the system.

National Saving

The goal of increasing national saving was central to the administration's thinking about Social Security reform. Conventional wisdom indicates that the nation should save more now in preparation for the retirement of the baby boom generation. With lower fertility and rising longevity, the output generated by each worker will need to support the consumption of a larger number of workers and retirees in the future than it does today. The nation can smooth consumption in the face of this rising dependency burden by setting aside a larger share of current output as saving, thereby increasing the future capital stock and making future workers more productive.

Despite this rationale, the economic case for increasing national saving is less clear cut than one might think. The fundamental issue is whether current generations should consume less in order to increase the well-being of future generations. In the absence of population aging, determining the optimal amount of saving involves balancing two considerations. On one hand, because future generations will benefit from gains in productivity over time, they are likely to be substantially better off than current generations. On the other hand, because foregone consumption compounds at the marginal product of capital, it is relatively inexpensive for current generations to provide additional resources for future generations.

Population aging introduces three additional considerations into the analysis. First, the increase in the dependency ratio caused by population aging will reduce the standard of living of future generations relative to what it would be without population aging, suggesting that additional resources should be transferred to future generations and therefore that additional saving would be desirable. Second, the slowdown in population growth will increase the capital-labor ratio, and therefore depress the return on capital; the lower return on capital suggests that less saving would be desirable (Cutler, Poterba, Sheiner and Summers, 1990). Elmendorf and Sheiner (2000) use simulations to quantify these effects and conclude that the United States probably should not undertake substantial additional saving in response to the anticipated demographic shock. A third consideration is that tax rates would have to rise significantly over time to fund current-law benefits on a pay-as-you-go basis. For example, current projections imply that the Social Security payroll tax rate would have to rise from its current level of 12.4 percent to about 18 percent by 2070, an increase of roughly half. Since deadweight loss rises

with the square of the tax rate, economic efficiency would be increased by raising taxes on current workers in order to decrease required future tax rates.

Quite aside from issues of population aging, many economists believe that a number of factors are causing U.S. national saving to be too low. For example, households may be short-sighted in their preparation for retirement, government policies may discourage saving by imposing a tax on capital income (interest, dividends, and capital gains), pay-as-you-go retirement programs like Social Security may crowd out private saving, and positive externalities from capital accumulation may drive the social return to saving above the private return.

It is very difficult to predict the impact of a given Social Security reform plan on national saving. For example, if budget policy is made with the aim of balancing the unified budget, any increase in Social Security surpluses will result simply in additional spending or tax cuts in the non-Social Security part of the budget. Similarly, households may respond to Social Security reform by changing their own saving in ways that offset additional saving generated directly by the reform plan. Elmendorf and Liebman (2000) estimate the effect on national saving of seven different approaches to Social Security reform and show that the effects of alternative reforms depend critically on how households and the rest of the federal budget respond to reform.

Saving Social Security First

Before the January 1998 State of the Union address, the administration's economic team presented President Clinton with three options for pursuing Social Security reform. The first was to make a surprise announcement of a complete reform plan in the State of the Union address. The second was to name a commission to produce a reform plan in a short time, with the aim of

engaging the Republican leadership in high-level negotiations in Spring 1998. The third was to launch a year of public education, with the aim of releasing a proposal after the fall 1998 Congressional elections, possibly in the 1999 State of the Union address.

As work progressed, the discussion ultimately focused on two possibilities. One was to allocate a specific percentage of the surplus to the Social Security trust fund and announce the date to which trust fund solvency would be extended by this action; the other was to reserve the entire surplus pending Social Security reform. The administration viewed the first proposal as a more dramatic announcement and an approach that would free up the remainder of the surplus for other priorities. But reserving all of the surplus was seen as a simpler and more sustainable message than announcing that some seemingly arbitrary fraction should be reserved. Moreover, it avoided the risk that a specific proposal to allocate surpluses to the trust fund would serve simply as a lightning rod for criticism and end up reducing the chance of achieving reform.

The administration ultimately adopted the second option, a strategy that became known as “Save Social Security First.” In the State of the Union address, President Clinton announced that his budget would reserve all of the projected unified budget surpluses pending Social Security reform. This strategy did not mean that the entire surplus would necessarily be used for reform, but rather that the President would not support other uses of the surplus—either for tax cuts or spending increases—until reform was accomplished and it became clear how much of the surplus was needed to finance that reform. Thus, the policy was intended both to preserve the projected surpluses in case they were needed to finance the transition to a more fully funded Social Security system, and to provide the reward of being able to use the remaining surpluses for tax cuts or more spending as an incentive to Congress for tackling Social Security reform.

President Clinton also launched a year-long national dialogue, including bipartisan forums designed to educate the public that would culminate in a December 1998 White House conference. At the first of these forums, in Kansas City, the President presented five principles that he said should guide Social Security reform: 1) strengthen and protect Social Security for the twenty-first century; 2) maintain universality and fairness; 3) provide a benefit people can count on; 4) preserve financial security for low-income and disabled beneficiaries; and 5) maintain fiscal discipline. The principles were designed to rule out proposals for radical privatization, including opt-out plans²¹, and proposals that would adversely affect low-income beneficiaries. The President also made clear that all reform options other than an increase in the payroll tax rate should be on the table. Throughout the year, President Clinton accepted the advice of his economic team and did not rule out an eventual increase in the normal retirement age. Moreover, the President consistently maintained that individual reform elements should not be judged in the abstract, but rather as components of complete plans, and that those plans should be evaluated against the principles he laid out in Kansas City. He thought that by providing cover for those who were willing to make politically unpopular proposals for Social Security reform, he could increase the chance that reform would ultimately be accomplished.

²¹ “Opt-out” plans – in which individuals could choose whether to remain in a scaled back version of the current system or to allocate instead a share of their payroll tax to individual accounts -- were considered particularly risky because high-income individuals might disproportionately opt out of the current system, turning it into a welfare program and depriving it of universal political support.

5. Social Security Reform Options

After the 1998 State of the Union address, the administration launched a systematic process to develop a Social Security reform plan. A working group jointly chaired by National Economic Council Director Gene Sperling and Deputy Treasury Secretary Lawrence Summers met once or twice nearly every week to develop and analyze reform options. These working group meetings culminated in meetings with the economic team principals roughly once every three weeks, and in intermittent meetings with the President that increased in frequency in advance of key decisions.

In order to be prepared for the debate that was expected to arise, the working group studied a wide range of reform options—including many that the administration opposed. To be clear, the President never determined whether there was any plan built around individual accounts that he could have supported. To our knowledge, he never gave any of his advisers a brief for negotiations with Congress, and the administration certainly was never on the verge of striking a deal. The President’s advisers rejected all plans for individual accounts that would have diverted resources away from the traditional defined-benefit program – so-called carve-out plans. Whether a so-called “add-on” plan could have garnered the support of the President is impossible to know. It was clear that any such plan would have put strict limits on the extent to which an individual’s overall benefit might be at risk from poor investment results, in line with one of the President’s principles for Social Security reform. Similarly, the administration would have put considerable emphasis on the redistribution accomplished under a proposed reform plan – again in line with one of the President’s principles – and might well have insisted that a reformed system be more progressive than the current one.

The working group studied analytic issues that cut across various reform options. Most of the analysis focused on two broad topics: mechanisms for using the projected budget surpluses to pre-fund Social Security benefits, and mechanisms for investing those pre-funded amounts in private financial assets. Much of the effort ultimately was directed toward devising ways of bridging the gap between defenders of the current defined-benefit system and advocates of individual accounts, including hybrid plans that included features of both approaches.

Relatively little time was spent analyzing traditional reform options such as raising the retirement age, adjusting the indexation of benefits, or changing the tax status of benefits. This lack of attention largely reflected the familiarity of these options, owing in part to the analysis conducted by the Gramlich Commission. What was new in the current situation was the availability of additional resources, in the form of emerging surpluses, that might be used to reduce the pain of putting the system on a sound footing. Moreover, it did not make much sense to focus on specific revenue raisers and benefit cuts until the President had settled on a particular approach to reform. Lastly, the administration believed that the specific painful elements of a Social Security deal would need to be introduced at the last minute as part of bipartisan negotiations with Congress. The administration's view was that any specific painful options put forward before a complete deal was reached would be attacked, and responsible policies would be taken off the table prematurely.

Using Projected Budget Surpluses as Part of Social Security Reform

There were two principal challenges in using near-term budget surpluses to help pay long-term Social Security benefits. The first challenge was to set aside the money today in a way that

would actually boost the resources available to future generations, rather than being dissipated down the road by future Presidents and Congresses. The second challenge was to ensure that the incremental future resources would actually be used to finance retirement benefits.

Maintaining budget surpluses – and thus paying down public debt – was seen as the most direct way to boost national saving, but by itself this approach had several shortcomings. First, it was not clear how to give Social Security a claim on the additional future resources that would be made available by paying down the debt. Second, this strategy would pay off the entire public debt long before Social Security was fully prefunded, raising the question of how the ensuing “national asset” should be invested. Third, it was difficult to see how this strategy could be locked in for any length of time: if future Presidents and Congresses decided to use the surpluses for tax cuts or new spending, then these resources would not be available as planned.

These concerns led the administration working group to devise a set of reform plans that involved transferring some portion of the unified budget surplus to the Social Security trust fund. Mechanically, these plans transferred funds from the non-Social Security part of the federal government to Social Security. If written into law, these transfers would have given Social Security a legal entitlement to future resources, and would have ensured that any later diversion of the surpluses to other purposes would have had an adverse implication for the Social Security trust fund. The transfers were also designed to take projected surpluses “off the table,” so that they could not be allocated to tax cuts or new spending, but would be used to reduce the public debt.

One important disadvantage of these plans was their vulnerability to the charge of “double counting” the Social Security surplus. Much of the projected unified budget surpluses

originated in Social Security and therefore were already credited to the Social Security trust fund under current law. Thus, according to the critics, transferring unified surpluses to Social Security caused the same dollars of revenue in effect to be counted twice to the benefit of Social Security. Yet, the status quo involved precisely the same approach to budgeting: as long as the budget process was focused on balancing the unified budget, dollars that were credited to the Social Security trust fund were still perceived to be available for new spending or tax cuts. The administration's economic team believed that a dollar of the unified budget surplus could therefore legitimately be transferred to Social Security and credited to the trust fund, provided that the dollar would take the dollar off the table and prevent it from being used for other purposes. In that case, the transfer would result in an extra dollar's worth of public debt being paid down relative to the status quo, and therefore in an extra dollar of government saving.

Nevertheless, the administration was well aware that this approach had "bad optics", and internally a number of economists argued vigorously against adopting a plan that would be subject to this criticism.²² However, the obvious alternative of taking Social Security out of the budget and transferring only non-Social Security surpluses to the trust fund was not a strong alternative at this point because the non-Social Security part of the budget remained in deficit. Thus, this approach would have imposed too much fiscal stringency and would have required the administration to give up talking about its proudest economic accomplishment, the unified budget surplus, and instead report an on-budget deficit.

²² In the Clinton White House, "bad optics" meant simply "did not look good."

Another disadvantage of this approach was the need for novel budget accounting in order to truly take the surpluses “off the table.”²³ Under conventional budget scoring, a dollar transferred from the non-Social Security part of the budget to Social Security would not reduce the unified budget—so the amount of surplus apparently available for tax cuts or new spending would not actually be reduced. Therefore, the administration proposed a new scoring rule in which every dollar transferred from the non-Social Security budget to the Social Security trust fund would result in a one-dollar reduction in the *reported* unified surplus. There was considerable internal debate over whether such a scoring rule would be sustainable, or whether some future President or Congress would revert to conventional scoring methods and erase the incremental government saving that would be achieved under this type of approach.

Investments in Private Financial Assets

Beginning with the Gramlich Commission, nearly all Social Security reform proposals involved some investments in private financial assets. Yet this consensus left a wide gap between those favoring individual accounts and those favoring collective investing through the Social Security trust fund. During the late 1990s, Henry Aaron, Peter Diamond, Robert Reischauer and others emphasized the high administrative costs and portfolio risks associated with individual accounts, and they devised mechanisms to protect collective investment systems from political interference (Aaron and Reischauer, 1998, Diamond, 1996, 1997, 2000). On the other side, Martin Feldstein, Andrew Samwick, and others argued that individual accounts need

²³ See Penner (1998) for a discussion of budget scoring issues that arise in Social Security reform plans.

not involve high costs or risks, and were the most effective way of pre-funding Social Security benefits (Feldstein and Samwick, 1997, 1998). The analysis conducted within the administration built upon this academic work and extended it significantly along four dimensions: administrative feasibility and costs, portfolio risk, political interference in markets and corporate governance, and redistribution.

Administrative Feasibility and Costs

Peter Diamond had shown that administering individual accounts had been very expensive in Chile and the United Kingdom, and argued that costs might also be high in the United States. In particular, he pointed out that an annual administrative cost of 100 basis points—similar to many U.S. mutual funds today—would reduce the retirement income available to an individual with 40 years of work history by roughly 20 percent. In order to ensure that the economic team’s advice to the President would be accurate and did not promise something that could not be achieved, Lawrence Summers insisted that the working group determine whether setting up an individual accounts system was even remotely feasible, what kind of service it could provide, and at what cost.

The information technology staff at the Treasury Department and the Social Security Administration were given the task of determining exactly how information and dollars would flow from workers’ earnings statements to private investment managers. Extremely detailed estimates were produced of how much additional manpower would be necessary for such a system to function. For example, one option was for workers to indicate their choices of private sector fund managers on their 1040 tax forms. The working group went so far as to determine

how many digits would be needed for each fund's ID number and therefore how many key strokes would be required to enter all of the ID numbers each year. Separate estimates of cost and necessary manpower were produced depending on whether the processing would occur by May of each year (sharply increasing IRS workload during its peak period) or by early August (which was much cheaper).

Two principal considerations were how long it would take to get a system up and running and whether the system could provide service similar to what many workers now experience in the 401(k) plans offered by their employers. On the first issue, it was considered important from a political standpoint that the system be up and running before President Clinton left office in early 2001. However, the information technology teams throughout the government were busy with Y2K preparations, so it did not seem possible that substantial resources could be devoted to setting up individual accounts until after those preparations were completed. At one point in mid-1998, consideration was given to starting the process of setting up the administrative structure for individual accounts right away, a year before there was any chance of a plan being enacted by Congress, so as to shave a year off the time between enactment and the existence of the accounts.

On the issue of service quality, a major concern of the working group was whether contributions could be made to individual accounts in a timely manner. Employers do not report their workers' annual earnings until the first quarter of the following year; it then takes the IRS several months to process and reconcile these earnings records, so it is typically August before a mostly complete set of earnings records for the previous year is available. The working group thought that it would be unappealing for account contributions to be made as much as 18 months

after the earnings on which they were based. Options were developed for making estimated contributions to accounts based on workers' previous years' earnings, or for investing all of the funds in a default portfolio and then allocating them to individual accounts (including the within-year returns) when the information on individual earnings became available.

Yet, the working group remained very concerned that any feasible, inexpensive individual account system would be perceived as providing inferior service compared with employer-run accounts. Because the cost of a system of individual accounts depends mainly on the number of accounts, rather than the amount invested in them, the existence in a public system of millions of very small accounts could generate administrative costs that were much larger on a "load" basis than for employer-run systems. Minimizing those costs would generally require a reduction in service and flexibility relative to those private systems. Thus, Lawrence Summers was fond of saying that we had to guard against the risk of setting up the Post Office when people were used to dealing with Federal Express.

The working group concluded that managing a system of individual accounts would be feasible, but that the government would have to play a major role in the system and only bare-boned accounts could be administered at a reasonable cost. In particular, the government would have to collect the revenue and set up a clearinghouse to direct deposits to the private sector fund managers selected by each worker. Other options such as having workers send contributions directly to fund managers or mandating that employers administer the accounts would be prohibitively expensive. One way to reduce costs was to allow people no investment choice until their accounts reached a minimum size (perhaps \$5000); until then the funds would be invested collectively. Moreover, the range of investment choices would need to be sharply limited, to

perhaps a dozen firms offering broad-based index funds. Account statements would be mailed at most once a year, and phone inquiries would not be toll-free. Borrowing against account balances would be prohibited, partly to preserve the balances exclusively for retirement use, and partly because load administration has proved very costly in the private sector.

The working group's best estimate was that such a system could be run at an annual cost of \$20 to \$30 per account, while accounts with service similar to that in current 401(k)s (though not including loans) would be two or three times as expensive. With roughly 180 million accounts, total annual costs could exceed \$5 billion a year in today's dollars (more than half as large as the current budget of the IRS and therefore more than half the cost of administering the entire federal tax code) and tens of thousands of new government workers would be needed to answer phone inquiries and process worker choices of fund managers. Thus, even though administering an individual account system was thought to be feasible, administrative costs remained a significant downside to that approach. The group also believed that it was important that costs be spread across all accounts in proportion to their assets; otherwise a very substantial share of the investment returns of lower-income people with small account balances would be consumed by the administrative costs.

Portfolio Risk

Social Security reform plans that involve investment in equities could introduce two sorts of portfolio risk. First, aggregate stock-market fluctuations could leave different cohorts with higher-than-expected or lower-than-expected retirement income. Second, retirement income could differ among members of the same cohort if individuals were allowed to make their own

investment choices. The extent of these risks varies considerably across different reform plans. Collective investment by the trust fund would produce no variation in benefits among members of the same generation, and—to the extent that there is some mean reversion in equity prices—could smooth some of the risk across generations as well. On the other hand, individual accounts with relatively unrestricted IRA-style investment options could result in substantial numbers of ill-informed investors making very different investment choices. As a result, two individuals born in the same year and with identical earnings histories might retire with very different benefits because they assumed different idiosyncratic risks or because aggregate stock-market fluctuations had affected them differently.

The economic team emphasized to President Clinton the portfolio risks under different reform proposals and the reasons to be cautious about equity investments. For example, the S&P 500 did not regain its 1968 value in real terms until 1983 (even including reinvested dividends), and Japan's Nikkei index had fallen by 60 percent since 1989. Moreover, a persuasive explanation for why the return on stocks in the twentieth century was so much higher than the return on bonds has never been given, raising concerns about whether this gap will persist in the future. Robert Rubin was particularly concerned about adding portfolio risk to the Social Security system, and he argued that it would be a mistake to have Social Security benefits depend on equity returns whether it was the trust fund or individuals doing the investing. He worried that the stock-market boom of the 1990s had erased people's memories of earlier periods such as the 1970s during which stock prices did not rise at all, and reminded the economic team of the *Business Week* cover story from 1979: "The Death of Equities?"

On balance, however, the economic team did not think that market risk was a sufficiently important concern to rule out plans that involved equities, for several reasons.²⁴ First, steps would have been taken to closely circumscribe the exposure of benefits to equity risk. If investment were undertaken, only a limited fraction of the trust fund would have been eligible for investment in equities. If individual accounts were part of the picture, they would have been small add-on accounts with limited investment options. Second, in the United States, even large stock market declines have ultimately been more than made up for in subsequent rebounds. For example, the S&P 500 lost 85 percent of its value between September 1929 and June 1932, but had returned to its 1929 level by the end of 1936. Nevertheless, there was some concern that there might not be sufficient political patience to remain invested in equities after a large market downturn. Third, although valuations were then very high relative to historic levels, a correction during the next decade or so would be relatively unimportant for retirement benefits since total equity holdings would not yet have grown very much. Fourth, under the reform plans the administration was considering, the existing Social Security payroll tax would still be allocated entirely to the purchase of Treasury securities by the trust fund. Only general revenue contributions to the system would be invested in equities. Thus, even in the unimaginable circumstance in which all of the stock investments became worthless (in which case, the solvency of Social Security would probably not be first on the list of the country's problems!), Social Security would be no worse off than under current law. Fifth, the current Social Security system already involves substantial risks, including the political risk that benefit rules will

²⁴ To be clear, the economic team nonetheless viewed risk as a significant downside of plans that involved equities, a downside that needed to be weighed against the possible advantages of equities.

change, the demographic risk that forecasts of mortality and fertility will be wrong, and the economic risk that productivity growth will be higher or lower than currently projected. Introducing equities would add a new form of risk, and might increase the total amount risk, but it would not be converting a currently riskless system into a risky one. Nonetheless, the economic team viewed market risk as a significant drawback of plans that involved equities, and this drawback would need to be balanced against any potential benefits of such an approach.

The administration working group also analyzed policy options that could reduce the risk faced by holders of individual accounts. One problem was that individuals might shift out of equities after a market decline, missing the recovery in equity prices. Another problem was that individuals who retired shortly after a substantial market drop—and annuitized their account balances based on those lower equity prices—might believe it was unfair that workers who had retired only shortly before were receiving much larger annuity payments. Indeed, this perceived unfairness might be acute even if the later retirees received higher annuities by investing in equities throughout their working lives than if they had invested entirely in government bonds. This issue could be addressed, at least in part, by mandating gradual annuitization or investment in variable-rate annuities, which would reduce the dependence of retirement income on equity prices at a moment in time. Another way to reduce risk would be a guarantee that each worker would do at least as well as if he or she had invested in government bonds. Yet, this approach presented the danger that guarantees would induce people to take too much risk in their portfolios or would simply represent a large contingent liability for the government.²⁵

²⁵ Indeed, research by Kent Smetters (2001) suggested that the contingent liability implicit in such a guarantee might be essentially as large as the unfunded liability in the current system.

Political Interference in Markets and Corporate Governance

Although the administration working group thought that centralized investment in equities had important advantages, the group also recognized that such investment had significant potential disadvantages. Chief among these was that government ownership of private financial assets raised difficult issues of corporate governance and potential political interference in capital markets.

Under the Social Security reform proposals of Robert Ball and Henry Aaron and Robert Reischauer, as much as 50 percent of the Social Security trust fund would be invested in equities. This holding would represent a large share of the U.S. stock market—somewhere between 15 percent and 30 percent in 2030, depending on the relative growth rates of GDP and the stock market. Even with a smaller part of the trust fund invested in equities, the government could still end up as the largest shareholder of many companies. If political considerations influenced the investment decisions of the trust fund, the efficiency of capital markets in allocating resources could be degraded. Certainly, the track record of state and local governments in the United States as well as foreign governments around the world was sufficient to give one pause on this issue. It is not difficult to compile a sobering list of examples in which political intrusion had materially reduced investment returns and arguably reduced the efficiency of various economies. Moreover, government ownership of equities might discourage the government from pursuing other policies that could lower equity prices. If the government were a major stockholder in Corporation XYZ, would the Justice Department shy away from pursuing a meritorious anti-trust

case against XYZ? Or would the Environmental Protection Agency or Occupational Safety and Health Administration refrain from enforcing their regulations against XYZ?

A related problem is how the government would exercise its rights as a shareholder to choose corporations' managers and participate in business decisions. Simply abstaining from voting might not be an adequate strategy since it could effectively turn minority shareholders into majority shareholders who would not necessarily look out for the interests of the other shareholders. In addition, voting rights may represent an important source of value in owning equity; would the government be fulfilling its fiduciary responsibilities if it simply ignored that source of value altogether?

Some members of the economic team believed that these problems were not insurmountable. They argued that investments could be handled by an independent board modeled after the Federal Reserve Board, with members chosen from the private sector and charged with acting in the sole interest of trust fund beneficiaries. Investments could be limited to "widely used index funds," in order to inhibit investments in index funds that excluded particular firms engaged in some specified out-of-favor activity. The private fund managers could be chosen in a competitive process, instructed to vote proxies on behalf of the trust fund's beneficiaries, and required to commingle the public money with the assets of their private clients. Even still, future Congresses could alter such safeguards at any time, so developing a culture of non-interference would be very important.

The working group also came to appreciate that many of these same issues would arise, to at least some degree, under a system of individual accounts, especially to the extent that investment choices were tightly constrained. Indeed, most legislation proposing individual

accounts would put strict limits on investment choices; it was not hard to believe that political interference might well affect the choices offered.²⁶ At the same time, individuals may be more vigilant in policing deviations from return-maximizing investment policies for accounts that they own personally rather than accounts that are held by the government—and Congress may therefore be more constrained in deviating from performance-maximizing choices with regard to such accounts. For example, the Thrift Savings Plan is a defined-contribution plan for federal employees that has existed for years without political interference.

Redistribution

A central principle for the administration was that Social Security reform should not reduce the extent of redistribution in Social Security from high-income households to low-income households. In particular, the administration believed that reform should help the demographic groups that are most dependent on Social Security for staying out of poverty, such as elderly women who are widowed, divorced, or never married. Indeed, Gene Sperling argued that any negotiations with Congressional Republicans about individual account plans should be limited to only those plans that would result in a more progressive system overall than current-law Social Security.

The most frequently proposed way of funding individual accounts was to make contributions proportional to an individual's earnings, such as two percent of earnings. Because

²⁶ For example, the Archer-Shaw proposal discussed later required all individual accounts to be invested in index funds with 60 percent equities and 40 percent bonds. The Breaux-Gregg-Kolbe-Stenholm plan limited investments to a small number of options similar to those in the federal Thrift Savings Plan.

this approach would provide no redistribution to lower-income workers, the administration working group studied other options for funding individual accounts.²⁷ One approach was to use the projected budget surpluses to fund equal-dollar contributions to each worker's account. Contributions of \$300 per worker had roughly the same aggregate cost as contributions of one percent of payroll, so contributions of \$600 would be a highly progressive alternative to contributions of two percent of earnings.²⁸ Contributions equal to \$300 plus one percent of earnings would come very close to replicating the redistribution in the current Social Security system.²⁹ In April 1998, Newt Gingrich proposed using the surplus to give every American a tax cut in the form of an equal-dollar contribution to a "Social Security Plus" individual saving account; thus, there was some hope that a plan along these lines could receive bipartisan support.³⁰

An alternative to funding individual accounts in a redistributive manner would be to make the traditional system more redistributive at the same time that non-redistributive individual accounts were introduced. This approach was used in the Breaux-Gregg-Kolbe-

²⁷ With mandatory annuitization at a single price, "two percent accounts" would appear to redistribute from poor to rich, because the rich tend to live longer. However, the overall distributional impact of such a plan depends on the source of the contributions. If the funding is generated from a progressive source like the personal income tax, then even accounts funded proportionally to earnings can be progressive.

²⁸ Contributions would likely be limited to workers with at least a threshold amount of earnings in the year (perhaps the amount that would qualify a worker for four quarters of Social Security coverage, currently around \$3000).

²⁹ See Feldstein and Liebman (2001) and Liebman (2001) for further discussion.

³⁰ Of course, there are many other redistributive formulas that could be used. For example, contributions could equal ten percent of the first few thousand dollars of earnings, five percent of the next few thousand dollars, and a smaller percentage of additional earnings.

Stenholm plan. The administration's economic team had serious concerns about this approach because it would lower even further the return received by higher income people in the traditional system, and thus run the risk of eroding support for a universal program.

The working group also gave a great deal of attention to ways of reducing poverty among elderly women. Elderly women who are divorced, widowed, or never married now have poverty rates around 20 percent, roughly twice the population-wide average. An inter-agency process developed a set of options for addressing this problem, and produced a report that was issued in conjunction with a Presidential event on the importance of Social Security to women.³¹ The options included: increasing Supplemental Security Income (SSI) benefits; providing Social Security earnings credits for years spent out of the labor force raising children; and offering a new widow benefit equal to 75 percent of the benefit received by the married couple before the deceased spouse passed away (capped at the benefit received by a worker with average earnings).³² These options were seen both as good policy and as a way to sweeten a Social Security reform package, particularly one with individual accounts, for Congressional Democrats. Although these proposals were never formally advanced by President Clinton, versions of them were put forth later by Vice President Gore during his Presidential campaign.

Another important concern was to make sure that Social Security reform did not reduce the income of Social Security disability beneficiaries. Because the formulas for retirement

³¹ *Women and Retirement Security*, available at www.ssa.gov/policy/pubs/womenrs.html.

³² Providing earnings credits for time spent out of the labor force raising children implicitly values that time the same regardless of a woman's earnings level. In contrast, the more traditional proposal to provide "drop-out" years in the Social Security benefit formula implicitly values the time of high-earning women more highly than the time of low-earning women. Thus, the new option was essentially a more progressive version of the traditional proposal.

benefits and disability benefits are linked, cuts to retirement benefits would generally reduce disability benefits as well. Yet, many disabled beneficiaries would not have had a chance to accumulate significant individual account balances by the time they become disabled, so they could not compensate for cuts to the traditional benefit using the proceeds of their individual accounts in the same way that retirees could. Therefore, the working group believed that any cuts to traditional retirement benefits should not pass through to disability benefits; all of the reform plans constructed by the group were scored under this assumption.

Potential Compromise Reform Proposals

The administration working group believed that there was more potential for substantive consensus on Social Security reform than the heated rhetoric on the topic suggested. Clearly, the political challenge of achieving reform was immense, and the substantive gap among competing proposals remained wide. Nonetheless, the administration believed that the concept of using the proceeds of fiscal discipline to help address the nation's long run fiscal challenges – and therefore to justify general revenue transfers to the Social Security trust fund – had the potential for bipartisan support. And on two of the most disputed issues—whether investments in private securities should be handled collectively or individually, and whether individual accounts should be created as part of Social Security—there was nearly a continuum of options, and proposals from the left and the right seemed to be moving toward each other.

On the first issue, proponents of individual accounts had originally argued that investment options should be completely unrestricted. For example, Martin Feldstein had initially proposed that individual accounts be funded through a tax credit and invested in any of the assets that are

eligible for use in an IRA. Yet, in response to concerns about administrative costs and naive investors, the main Republican legislative proposals ended up restricting investment choices to a few broad index funds. Similarly, early plans for private investments by the Social Security trust fund envisioned the government investing directly through a single large fund. But as concerns about government interference in markets were raised, proposals tended to set up independent investment boards and to spread the investments across a number of private managers. Thus, by late 1998, alternative investment mechanisms appeared to be converging to some degree.

A similar convergence may have been occurring on whether individual accounts should be part of Social Security. Some Democrats argued that individual accounts had the potential to create wealth for all Americans, provide choice for individuals, and allow for some bequests.³³ Other Democrats were willing to consider supplementing Social Security benefits with government-subsidized accounts targeted at low-income households. At the same time, some Republicans who had initially favored diverting a portion of the existing Social Security payroll tax to individual accounts—and then cutting the traditional benefit substantially—turned to proposals in which general revenue was used to fund individual accounts.³⁴ Indeed, there was a growing understanding that reshuffling the revenue stream already dedicated to paying retirement benefits would not help close the underlying financing gap, and that additional resources would

³³ Clearly, an individual account system that allowed for bequests would have lower average retirement benefits than a system that used the account balances of deceased workers to supplement the retirement benefits of survivors—unless additional resources were contributed to the system.

³⁴ In some of these plans, part of the Social Security payroll tax was diverted to individual accounts, while general revenue was directed to the trust fund to make up for the diverted monies.

be needed. Moreover, some of the Republican proposals involved redistributive funding of individual accounts. Thus, by late 1998, there appeared to be the possibility for convergence around using non-Social Security funds to make redistributive contributions to individual accounts, contributions that might or might not bear any direct mechanical relationship to the traditional Social Security system.

Three main types of Social Security reform plans occupied the “policy space” defined by this possible convergence of views. The first and simplest were add-on individual accounts like those proposed by Edward Gramlich. Under this approach, the entire existing Social Security payroll tax would continue to be used exclusively for funding traditional Social Security benefits, and benefit cuts and revenue raisers would be used to bring the system into financial balance. At the same time, general revenue would be contributed to individual accounts to compensate for the reduction in the traditional benefit.³⁵

The second type of eligible plan was a so-called “clawback” plan, initially developed by Martin Feldstein and Andrew Samwick. Under this approach, general revenue from the budget surplus would be contributed to individual accounts, and a significant share of the account balances (possibly in excess of 75 percent) would be “clawed back” when workers reached retirement in order to finance traditional Social Security benefits; individuals would receive the

³⁵ It would also be possible to fund add-on accounts by requiring workers to make mandatory contributions to these accounts above and beyond their current payroll taxes. This approach was taken in the Gramlich plan.

remaining account balances directly.³⁶ House Ways and Means Committee Chairman Bill Archer and his colleague Clay Shaw introduced a plan of this form.

The third type of possible consensus plan was a so-called “hybrid” plan that included both trust fund investments in equities and the establishment of small individual accounts. Some analysts saw these plans as “splitting the difference” between the two sides in the political debate. In addition, this approach offered an interesting opportunity for addressing concerns about government interference in markets: trust fund investments could simply mirror the investment choices that individuals made in their own accounts. This could be done through a single fund that matched the aggregation of individuals’ choices, or it could be done through individual “mirror accounts” in the name of each worker that were invested on behalf of the trust fund. On the other hand, some analysts argued that the smaller individual accounts in hybrid plans made little sense, because the fixed costs of administering the accounts would consume an excessive fraction of the investment returns.

An important concern of the economic team was that a reform plan involving modest individual accounts in the beginning might be a “slippery slope” toward total privatization. Yet, there was considerable disagreement about what sort of reform presented the greatest such risk. Some members of the team argued that a clawback approach would best preserve the existing system, since nearly all of the retirement benefits would continue to be paid out through the traditional defined-benefit formula. From that perspective, a clawback plan could be viewed as a

³⁶ A typical proposed clawback rate was 75 percent, leaving 25 percent of the account balances for individuals to consume directly. The clawback can also be specified as a reduction in Social Security benefits equal to some fraction of account withdrawals. For example, a worker might lose 75 cents of his or her traditional benefit for each dollar of retirement income from an individual account.

back-door way for the Social Security trust fund to invest in equities while leaving the investment decisions to individuals rather than the government. Other members of the economic team argued that the clawback approach tied Social Security benefits too closely to individual accounts, and that it would not be politically feasible to tax such a large portion of the accounts at retirement. Under this view, clawback plans were simply a way of building up sufficient assets to make total privatization possible (and likely) at a later date.

More generally, the working group recognized that the details of reform proposals would have a tremendous impact on their economic and social consequences—and thus on the acceptability of those proposals to the administration. Thus, an “individual accounts” proposal that was funded out of the existing payroll tax in a non-progressive manner with unrestricted investment options and high administrative costs represented a completely different view of the future than a proposal with a similar label but different funding source and account design.

The 1999 State of the Union Social Security Proposal

Throughout 1998 the administration working group studied the analytic issues underlying Social Security reform and constructed specific illustrative reform plans. Briefings for President Clinton covered not only the substantive issues detailed in the preceding pages, but also political strategies for achieving bipartisan agreement on reform. Options that were given some very preliminary thought included: the “Andrews Air Force Base approach,” echoing the negotiations over the 1990 budget deal, in which White House officials and the Congressional leadership were sequestered in non-stop negotiations at the base just outside Washington, DC; the “spontaneous” emergence of a bipartisan piece of legislation from a moderate Democrat on the Senate Finance

Committee, as had almost worked on tobacco legislation; and the formation of a commission made up of key members of Congress and administration officials.

The administration also spent 1998 pursuing an active “external” strategy on Social Security reform. This effort included briefings for members of Congress, public education efforts surrounding the three national Social Security forums, and preparation for the December White House conference. Congressional distrust of the administration’s work on Social Security reform ran very deep, in part because of the potentially momentous importance of the issue. Some Democrats doubted whether the administration had a bedrock commitment to preserving Social Security in its current form to the greatest extent possible. Congressional Republicans were even less trusting of the administration, and they sought assurances that President Clinton was serious about achieving bipartisan reform and not simply trying to trick Republicans into taking an unpopular position on the issue that Democrats could then use to re-take control of the Congress. Indeed, when Archer and Shaw introduced a specific reform plan, some of their Republican colleagues complained that they had fallen into the Clinton administration’s trap.

In the end, President Clinton decided to pursue Social Security reform based on bolstering the Social Security trust fund rather than on creating individual accounts. The President proposed transferring general revenue into the trust fund and investing a portion of the transferred amounts in equities. The equity investments would be restricted to never exceed five percent of the total U.S. stock market. This decision may have been influenced by the changing political dynamic in late 1998, as the possibility that the President would be impeached came clearly into view. Whether the President would have pursued a different approach in the absence of impeachment will never be known.

The other key decision that was made in the run up to the 1999 State of the Union address was whether to stick with a unified budget framework or to switch to a budget framework that allocated only the non-Social Security surplus. The central advantage of the unified budget framework was that there would be sufficient funds available not only to shore up Social Security but also to extend Medicare solvency, provide for additional discretionary spending, and establish progressive individual savings accounts outside of Social Security. A key disadvantage was that transferring a portion of the unified budget surplus to Social Security might be seen as “double counting.” In contrast, the on-budget approach would avoid the double counting critique, but there would not be sufficient resources available for all of the non-Social Security initiatives. Moreover, it would be necessary to project on-budget deficits for some of the individual years in the ten-year budget window. Ultimately, the President decided to stick with the unified budget approach to budgeting that had been the norm since the Johnson Administration.

6. Budget Surpluses: 1998 through 2000

During the final years of the Clinton administration, attention focused on the rapidly rising budget surpluses and their appropriate disposition. We review the economics and politics of that budget debate in this section.

The 1999 State of the Union Budget Framework

In his 1999 State of the Union address, President Clinton built on the earlier strategy to “Save Social Security First” by proposing a specific budget framework for Social Security reform

and long-term fiscal discipline. This framework proposed an allocation of *unified* budget surpluses. In contrast with prevailing practice, this allocation extended over the unusually long time frame of fifteen years because there were insufficient resources in the first ten years to accomplish all of the President's objectives. In line with the earlier strategy, all of the proposed uses of the surpluses were conditioned on reforming Social Security.

The proposed allocation of the unified surpluses was as follows: First, 62 percent of the surpluses were allocated to Social Security and 15 percent to Medicare. Transfers in these amounts would be made to the respective trust funds, and the associated budget resources would be viewed as fully "used" and hence not available for other purposes. Because the monies were not needed by these programs to pay current benefits, they would be used predominantly to pay down the publicly held debt of the Federal government, with a limited amount of the revenue transferred to Social Security used to purchase equities. The plan was projected to extend the solvency of the Social Security trust fund to 2055 and the Medicare Part A trust fund to 2020.

Another 12 percent of the surpluses were allocated to create new Universal Savings Accounts (USAs). As the administration described in more detail later in the spring, the accounts would involve an automatic contribution by the government for all workers earning less than a specified amount, as well as a matching contribution also available to workers with income below a certain threshold. A primary motivation for these accounts was to serve as a bridge between the proponents and opponents of introducing individual accounts into the Social Security system. On one hand, USAs gave the administration a means of promoting wealth creation on a broad scale, and they signaled the President's willingness to discuss the appropriate role of individual accounts in the U.S. retirement system. On the other hand, the administration

emphasized that the accounts would have been entirely separate from Social Security—funded from revenue outside the existing payroll tax, and having no implication for an account holder’s traditional Social Security benefits. Indeed, to reinforce the separateness of USAs from Social Security, and to ensure that USAs were not seen as undermining the existing private pension system, the administration proposed that contributions to 401(k) plans would qualify for government matching. As it turned out, however, USAs never received serious legislative consideration.

The budget framework also allowed for additional tax cuts for child care, long-term care, school construction, and investment in economically depressed areas, but the cost of these proposals was financed entirely by other revenue-raising provisions such as curtailing tax subsidies and closing some tax shelters and other loopholes. The final 11 percent of the surpluses were allocated to military readiness and other spending.

Federal Reserve Chairman Alan Greenspan testified to Congress on the day after the State of the Union address. His prepared remarks concerned macroeconomic conditions and therefore did not mention the President’s proposals of the previous evening. However, in the question-and-answer session, he provided crucial support for transfers to the Social Security trust fund while reiterating his strong opposition to government investment in private markets:

[Greenspan] endorsed President Clinton’s proposal to let federal budget surpluses accumulate by locking up most of the money in the Social Security and Medicare trust funds. But he attacked Mr. Clinton’s plan to invest as much as 15 percent of the Social Security trust fund in the stock market, arguing that it would be “virtually impossible” to insulate investment managers from political influence. – *Wall Street Journal*

Much of the media coverage focused on Greenspan's opposition to government ownership of private equities. Even so, these testimonies helped the administration build credibility within the Beltway for the plan's central device for preserving a large fraction of the unified surpluses.

The proposed budget framework was also criticized on the grounds that it "double counted" the projected Social Security surpluses. As we discussed earlier, the unified surplus equals the "off-budget" surplus (overwhelmingly the Social Security surplus) plus the "on-budget" surplus (essentially, the surplus on the non-Social Security portion of the government's operations). The critics argued that the administration's plan for allocating unified surpluses was transferring to Social Security some budgetary resources that had originated in the Social Security system, and therefore had already been credited to the Social Security trust fund once. Consider, for example, the hypothetical case in which *all* of the unified surpluses originated in Social Security. In that case, a \$1 surplus in the Social Security system would have increased the trust fund balance by \$1.62—\$1 as under current law, and an additional 62 cents from the proposed transfers. The administration responded that the budget debate in preceding decades had been a debate about the unified budget, with an implicit—though often unspoken—objective of balancing the unified budget. By contrast, the administration now aimed to leave a unified surplus. If one accepted the administration's assertion that "business as usual" would have left no unified surpluses, then the State of the Union plan generated incremental government saving, and the budget framework simply proposed to allocate this incremental saving to Social Security.

Republicans responded to the President's proposals by pledging to create a "lockbox" to ensure that the Social Security surplus would be used to pay down debt. In addition, they

proposed to allocate the on-budget surplus primarily to a ten percent across-the-board tax cut and increases in defense spending.

Balancing the Budget Excluding Social Security

Against a backdrop of the double-counting allegation and continued dramatic improvement in budget projections, the administration significantly revamped its budget framework for the Mid-Session Review (MSR) released in June 1999. The new framework proposed to balance the budget in each year *exclusive of the operations of the Social Security system*. The MSR projected that the on-budget account would run a surplus of \$5 billion in fiscal year 2000 if no policy changes were enacted; as it turned out, the on-budget account finished fiscal year 1999 with a surplus of less than \$1 billion, the first surplus by that measure in 40 years, and followed that with a surplus of more than \$86 billion in fiscal year 2000.

The Logic

Social Security had been taken officially “off-budget” in 1983, and this action was reaffirmed in the budget legislation of 1985 and 1990 (Koitz, 1998). But none of this legislative action was sufficient to redirect policy attention to the on-budget balance. The key objective of the administration and others who favored the MSR approach to budgeting was to refocus the political conversation on the disposition of the on-budget surpluses. This step would establish the presumption that the Social Security surpluses would result in unified surpluses of at least the same size on average, and thus be used to pay down public debt. While the new framework

clearly had political value to the administration in potentially blocking Republican tax-cut proposals, it was also motivated by economic policy considerations.

The administration's economic team viewed the MSR approach as significantly improving the legitimacy of the Social Security trust fund as a mechanism for pre-funding the government's future retirement-related obligations. Under the old approach, in which the implicit fiscal objective was to balance the unified budget, an incipient Social Security surplus would tend to elicit either tax cuts or new spending. Depending on the size of this offset, the net result could be little or no government contribution to national saving, even though the balance in the Social Security trust fund would have increased. Thus, in the preceding fifteen years, Social Security surpluses probably raised government saving by much less than 100 percent of the accumulation in the trust fund. In essence, the nation had been doing less to prepare itself for the retirement of the baby-boom generation than one would have thought by looking at the rising trust fund balance.

In contrast, the new approach implies that Social Security trust fund accumulations would be backed, dollar-for-dollar, by government contributions to national saving. By itself, the new approach leaves open the question of *how much* pre-funding of future Social Security obligations should be undertaken, but it provides much more assurance that the government is doing as much pre-funding as it appears to be doing.³⁷ By bringing trust fund accumulations and increments to government saving into alignment, the new framework took an important step toward “truth in

³⁷ One view is that the objective of balancing the on-budget account should be complemented with the objective of putting the Social Security system into some form of long-term actuarial balance. Determining how to satisfy that second leg of the overall fiscal objective would supply the answer as to *how much* prefunding we should be undertaking.

government.” Put differently, this approach takes the “double counting” critique completely off the table, because Social Security surpluses unambiguously would be “used” once and only once (to pay down the debt held by the public).

The new framework also provided an organized context for executing general revenue transfers into the Social Security trust fund. Such transfers would be scored as an “expense” of the on-budget account; if the accepted goal is to balance the on-budget account, then this expense would reduce the resources available for other uses. As a result, all accumulations in the trust fund would be matched, dollar for dollar, by an incremental increase in government saving. In this budget framework, general revenue transfers to Social Security are not simply a paper transaction, but generate true economic pre-funding of future obligations. The administration proposed sufficient transfers in the 1999 MSR to extend the solvency of the Social Security trust fund to 2053. To motivate a specific amount of those transfers, they were set equal to the interest savings that would result from using the Social Security surpluses to pay down public debt rather than cut taxes or raise spending. The transfers would have begun in 2011 based on debt reduction in the preceding decade.

The MSR plan did not fully resolve the difficulties with general revenue transfers, because it left Medicare as part of the on-budget account while proposing to transfer general revenue into the Hospital Insurance (Medicare Part A) trust fund. Under traditional budget scoring rules, the net effect of these transfers on the on-budget surplus would have been zero, because the transfers would have appeared as both an outlay and a receipt. To deal with this problem, the administration adopted the obvious modification to the usual accounting rules—treating the transfers as a “full use” of those monies, and therefore as reducing the amount

of on-budget surpluses available for other uses. The proposed transfers were projected to extend the solvency of the Medicare trust fund to 2027, by far the longest solvency horizon in the history of the program. However, no action was taken by the Congress to implement either the Social Security or Medicare transfers.

The Lockbox

Because the details of national saving and budget accounting are not viewed as attractive material for political messages, the new approach was proposed to be implemented through creation of a Social Security “lockbox.” The lockbox was designed to create a mental picture of a strong safe that would contain not only the current-law Social Security surpluses but also the proposed general revenue transfers. By placing these funds in a “lockbox,” the administration meant to increase the public’s assurance that those monies would be saved—which in this instance meant that they would be used to pay down debt held by the public. The substance of the lockbox consisted of a set of procedural hurdles that the Congress (and especially the Senate) would have to overcome before the government could run a deficit in the on-budget account.

That said, the most important guarantor of the new framework is something more amorphous—specifically, the terms of the political debate. So long as the political debate focuses on the disposition of the on-budget surpluses, the procedural hurdles underlying the lockbox probably will not come under serious challenge. But if the consensus changes, the Congress will find ways around those hurdles. Thus far, the political consensus appears to be holding, and it remains politically dangerous to “dip into the Social Security surpluses.”

However, it is far from certain that this consensus will continue to hold if the on-budget account returns to deficit.

A critical factor that smoothed the way to shifting the focus of the budget debate was the ongoing improvement in the fiscal situation. After the budget stringency that had been required to balance the budget on a unified basis, there would have been little appetite for balancing the on-budget account if doing so would have entailed substantial additional pain. That said, it would be a mistake to underestimate the discipline that was required to achieve the higher standard. At every step of the way, the opportunity cost in terms of foregone tax cuts and additional spending was keenly felt.

Congressional Republicans generally embraced the shift in budget objective toward balancing the on-budget account, but they rejected President Clinton's proposed disposition of the projected on-budget surpluses. In the MSR plan, the President allocated these resources to transfers to Social Security and Medicare, new spending (especially a Medicare drug benefit), and a limited set of tax cuts. The framework also incorporated a comprehensive reform of Medicare, which is discussed in greater detail by Newhouse (this volume). All told, the debt held by the public would have been paid off, on a net basis, by 2015 under the President's plan. In contrast, Congressional Republicans continued to place much greater emphasis on tax reduction—at one point proposing that the entire projected on-budget surpluses be devoted to a tax cut, and providing no new resources for either Social Security or Medicare.

During its last year the Clinton administration framed its fiscal policy around the goal of eliminating the debt held by the public. Treasury Secretary Summers explained the logic of this objective in a May speech. First, Summers argued, paying down the debt “will maximize investment at a time when the reward for investing is especially great.” Summers piggybacked on the observation of Alan Greenspan that the return to investment appeared to be historically high, and therefore that the opportunity cost of failing to invest also was historically high. Second, paying down the debt “will help to increase supply in our economy, rather than demand.” The economy was then operating beyond its normal productive capacity, and even the administration’s own economic projection showed a gradual upward drift in the unemployment rate over the succeeding few years. Against that backdrop, many analysts believed that fiscal policy should aim to increase aggregate supply by adding to the available pool of capital, rather than fueling aggregate demand. Third, a failure to pay down debt “is likely to exacerbate the U.S. trade deficit.” The size of the trade deficit may just have reflected the relative economic strength of the United States and its major trading partners. But it was one of the few economic imbalances at the time, and the moment seemed inopportune for a more expansionary fiscal policy that might appreciate the dollar, reduce foreign demand for our goods and services, and increase our demand for theirs. Fourth, Summers said, a failure to pay down debt “will reduce our capacity to meet the demographic challenges ahead.” Summers strongly endorsed the view that the most important preparation the federal government could make for the retirement of the babyboom generation was to improve its fiscal position, thereby increasing national saving and expanding the productive capacity of the economy. And finally, “the current strength of our economy and budget, combined with the enormous uncertainty attached to budget projections,

make this a time when we should be prudent in our commitments.” Summers argued implicitly that it was preferable to be too cautious rather than too aggressive in extrapolating recent economic performance.

In line with this view, the administration’s budget framework released in early 2000 was aimed at preserving fiscal discipline. The projected Social Security surpluses were again protected in a “lockbox,” and the administration again proposed that general revenue be transferred to the Social Security trust fund and added to the “lockbox.” These transfers would begin in 2011 based on the interest savings from debt reduction between 2000 and 2010. Roughly \$300 billion in general revenue would be transferred to the Medicare trust fund over ten years and used for debt reduction. The remaining on-budget surplus was divided into nearly \$200 billion of additional spending for a prescription drug benefit for Medicare beneficiaries and health insurance coverage for low-income Americans, and more than \$250 billion of tax cuts focused on retirement saving, marriage penalty relief, educational opportunities, community revitalization, affordable health care, and tax simplification.

In June the administration announced another upward revision to the baseline budget surpluses over the next ten years, this time in the amount of \$1.3 trillion. The Mid-Session Review proposed the next step toward shoring up the conceptual foundations of the budget by taking Medicare out of the budget in the same way that Social Security was out of the budget. Accordingly, the MSR allocated baseline surpluses over the following ten years *excluding both Social Security and Medicare*. The administration maintained its policies on Medicare reform, health coverage, and targeted tax cuts, and set aside \$500 billion as a “reserve for America’s

future.” Even if all of these funds were used for spending increases or tax reductions, the debt held by the public was still projected to be paid off, on a net basis, by 2012.

The Congress did not adopt the central features of this budget framework. Neither Social Security nor Medicare reforms were enacted.³⁸ Although no fewer than five “lock box” bills to set aside both the Social Security and Medicare surpluses passed the Republican-controlled House between 1999 and 2001, none were passed by the Senate and therefore no legislation taking Medicare out of the budget (which would have given it the same treatment as Social Security) was ever enacted.

Just working out the annual appropriations bills proved an especially arduous undertaking: a succession of continuing resolutions kept the government functioning after the beginning of the new fiscal year on October 1, and the final bills were not approved until December 15. President Clinton announced the administration’s final set of budget projections in late December. Based on these projections, the debt held by the public could be eliminated on a net basis by 2010.

A National Asset

³⁸ Notable changes to the Social Security earnings test did occur during this decade. The earnings test reduces or eliminates benefit payments to beneficiaries with income from work that exceeds a threshold amount. These beneficiaries subsequently receive higher benefits to compensate them for the withheld benefits. Legislation in 1996 significantly raised the level of earnings that would trigger benefit reductions. Legislation in 2000 eliminated the earnings test altogether for beneficiaries who are at or above the normal retirement age (currently 65 years and two months and scheduled to increase to 67 by 2022). See Gruber and Orszag (2000) for an overview of the impact of the earnings test on labor supply and benefit receipt.

Toward the end of the Clinton administration, the possibility of eliminating the debt held by the public became increasingly realistic. The arithmetic associated with this possibility is straightforward: if the on-budget account is kept in balance over the next ten to fifteen years, the Social Security surpluses will be enough to pay down the entire public debt. Beyond that point, the continued Social Security surpluses that are now projected would transform the Federal government from a net debtor to the rest of the economy into a net creditor. In other words, the government might become a net holder of private assets.³⁹ The Clinton administration recognized this possibility, but did not wrestle with the associated policy issues at any great length.

Indeed, under current projections, the accumulation of assets is likely to begin even sooner than the basic math suggests. First, part of the debt held by the public is in forms that would be difficult or unpopular to retire. For example, there are roughly \$200 billion in outstanding savings bonds, and this program—which provides a convenient savings vehicle especially for low- and moderate-income households—seems unlikely to be terminated in the name of increasing national saving. Second, part of the debt is scheduled to mature well after the debt would be eliminated on a net basis. Some portion could be bought back before its scheduled maturity date, but at some unknown point, the holders of this long-term debt might demand an

³⁹ In some very limited respects, the Federal government already holds private assets. For example, the Treasury maintains cash balances in commercial banks, the Thrift Saving Plan holds equities on behalf of its individual beneficiaries, and the Pension Benefit Guarantee Corporation holds private assets in part as legacies from retirement plans that have been turned over to it. However, these current holdings are dwarfed in size by the investments that might be conducted on behalf of the Social Security trust fund or the central government.

increasing premium in order to give it up.⁴⁰ In sum, the debt elimination date is only about a decade away, assuming that Social Security surpluses materialize as projected and continue to be used to pay down debt.

Accumulation of private financial assets by the Federal government raises all of the same issues regarding corporate governance and potential political interference in capital markets that arise when considering whether to invest part of the Social Security trust fund in private assets. Indeed, some have argued that the dangers are even greater in this situation, since the Social Security trust fund is at least somewhat removed from the political process and is intimately linked with a popular cause and powerful lobby. In general, the same potential solutions to these problems pertain. The federal government could attempt to set up a neutral, nondistortionary method of investing the surplus monies in the private market, running all the risks that would be inherent in that approach. Alternatively, the Social Security trust fund could invest in private securities, thereby commensurately increasing the amount of government debt in private hands. Still another possibility is that individual accounts might be used to preserve some of the saving inherent in the projected surpluses, while reducing (though not avoiding altogether) the governance and political interference concerns associated with centralized investment. Finally, increases in spending or larger tax cuts obviously could eliminate unwanted asset accumulation, though at the sacrifice of some or all of the potential government contribution to national saving. Such a return to balancing the unified budget instead of the budget excluding Social Security

⁴⁰ The extent of this problem depends on the Treasury Department's debt issuance policy from here forward. Already, there has been considerable speculation in the financial press that Treasury's 30-year bonds might be discontinued because new bonds of that maturity would extend so far beyond the currently projected debt-elimination date.

would also break the link between government saving and the accumulation in the Social Security trust fund, impairing the validity of that fund as a signal of the preparation that the nation is undertaking for the retirement of the baby-boom generation.

The current long-term outlook for fiscal policy also raises questions with regard to the social value of Treasury debt. In particular, a number of commentators have pointed out that the existence of a deep and liquid market for Treasury securities has provided significant benefits to U.S. capital markets. For example, Treasury securities have served as pricing benchmarks for other debt instruments, meaning that prices and yields on corporate and other securities are often quoted relative to Treasury securities rather than in absolute terms. In addition, Treasury securities have been seen as convenient vehicles for hedging interest-rate risk.

Yet, it is not evident whether these functions require the existence of Treasury debt *per se* or simply the existence of some debt market that is very deep and very liquid. Indeed, as market participants have come to recognize the possibility of at least a substantial paydown of Treasury debt (even if not total elimination), there has been substantial market innovation. Alternative instruments are now vying for the role that has been played by Treasury securities; where this process will lead is unclear, especially because the market may dictate that there is room for only one successor rather than many.⁴¹ Thus, the current situation leaves open the question of whether a large market for Treasury securities provides some benefit for the economy that: (a) cannot be provided by any private issuer, (b) can be provided more efficiently by the Federal government, or (c) represents a valuable monopoly franchise that should be provided by the Federal

⁴¹ If there were more than one potential successor to Treasury debt, the market might eventually “tip” to one or the other in order to gain the extra efficiency associated with maximum depth and liquidity in a single market.

government so that taxpayers can reap the financial rewards rather than private monopolists. Quantifying the benefits of a deep and liquid Treasury market is very difficult. Moreover, those benefits must be weighed against the costs of either less saving or the holding of private assets by the government. Indeed, if the social value of government debt is great enough, it could even be optimal for the government to gross up its balance sheet by issuing extra debt and purchasing private assets simply to maintain a viable debt market.

7. Conclusion

The 1990s were marked by an unexpected turn-around in the U.S. fiscal situation as a seemingly intractable budget deficit problem gave way to large budget surpluses.⁴² A potent symbol of the improvement in the fiscal situation over the decade was the announcement on May 13, 2000 that the “debt clock” in New York’s Times Square would be dismantled in September 2000, essentially for lack of interest.⁴³ The tax increases and spending discipline imposed by the 1990, 1993, and 1997 budget deals played a significant part in this improvement in the budget picture, as did the restraint of the Congress and the President from enacting tax cuts or spending increases that would have dissipated the incipient surpluses. But good luck in the form of a strong economy also was important. And the impact of the initial policy decisions on the subsequent economic performance should not be discounted.

⁴² Larry Lindsey is the only person we are aware of who predicted this transformation. His 1990 book, *The Growth Experiment* contains a chapter titled “The Great Surplus of ‘99.”

⁴³ See <http://www.cnn.com/2000/US/09/07/debt.clock/>

While the Clinton Administration's fiscal policy helped to bring the budget deficit under control and reduce the level of debt to GDP from 50 percent down to 35 percent, the Administration was only partially able to lock in fiscal discipline for the future. The consensus that emerged in 1999 to pay down debt with the Social Security surplus will, assuming the consensus holds, ensure that the debt to GDP ratio continues to fall steadily for the next decade. But the Administration's attempts to preserve the budget surpluses to help solve the entitlement problem ended in failure as it took the subsequent Administration less than six months to dissipate much of the surpluses by passing a large consumption-oriented tax cut. Given the magnitude of the long-run fiscal imbalance and of the budget surpluses that could potentially have been allocated to address this problem, a significant opportunity to prefund future retirement and health benefits was missed.

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Table 1
The Turnaround in the Federal Budget
 (share of GDP; fiscal years)

Year	Unified Budget Balance	Receipts	Non-Interest Outlays	Debt Held by Public	Individual Income Taxes	Defense Spending	Entitlement Spending
1986	-5.0	17.5	19.4	39.6	7.9	6.2	10.5
1987	-3.2	18.4	18.6	40.6	8.4	6.1	10.2
1988	-3.1	18.1	18.2	40.9	8.0	5.8	10.1
1989	-2.8	18.3	18.1	40.5	8.2	5.6	10.2
1990	-3.9	18.0	18.6	42.0	8.1	5.2	10.9
1991	-4.5	17.8	19.0	45.4	7.9	5.4	11.8
1992	-4.7	17.5	19.0	48.2	7.7	4.9	11.5
1993	-3.9	17.6	18.5	49.5	7.8	4.5	11.2
1994	-2.9	18.1	18.1	49.4	7.8	4.1	11.3
1995	-2.2	18.5	17.5	49.2	8.1	3.7	11.2
1996	-1.4	18.9	17.2	48.5	8.5	3.5	11.1
1997	-0.3	19.3	16.5	46.0	9.0	3.3	10.9
1998	0.8	19.9	16.3	42.9	9.6	3.1	10.8
1999	1.4	20.0	16.1	39.7	9.6	3.0	10.7
2000	2.4	20.6	15.9	34.7	10.2	3.0	10.5

Source: CBO (2001).

Table 2
Sources of Improvement in the CBO's Budget Projections

Source of Revision	Revision to Projected 5-Year Surplus	Revision to Projected 10-Year Surpluses		
	from Jan. 1990 to Jan. 1993	from Jan. 1993 to Jan. 1995	from Jan. 1995 to Jan. 1998	from Jan. 1998 to Jan. 2001
Total	-\$782 billion (100%)	\$1603 billion (100%)	\$3107 billion (100%)	\$3196 billion (100%)
Policy	460 (59%)	1570 (98%)	501 (16%)	-1606 (50%)
Economic	-330 (42%)	-39 (2%)	1272 (41%)	2669 (84%)
Technical	-337 (43%)	44 (3%)	1247 (40%)	2126 (67%)
Other	-575 (74%)	28 (2%)	87 (3%)	7 (0%)

Notes. Revisions are from January to January of the years shown. Decomposition is by the CBO, cumulated by the authors across projection updates. Percentages apply to the total revision during the period indicated without regard to sign.

Figure 1: Federal Budget Surplus : 1946 - 2000

(percent of GDP)



Figure 2: Debt Held by the Public: 1946 - 2000

(percent of GDP)

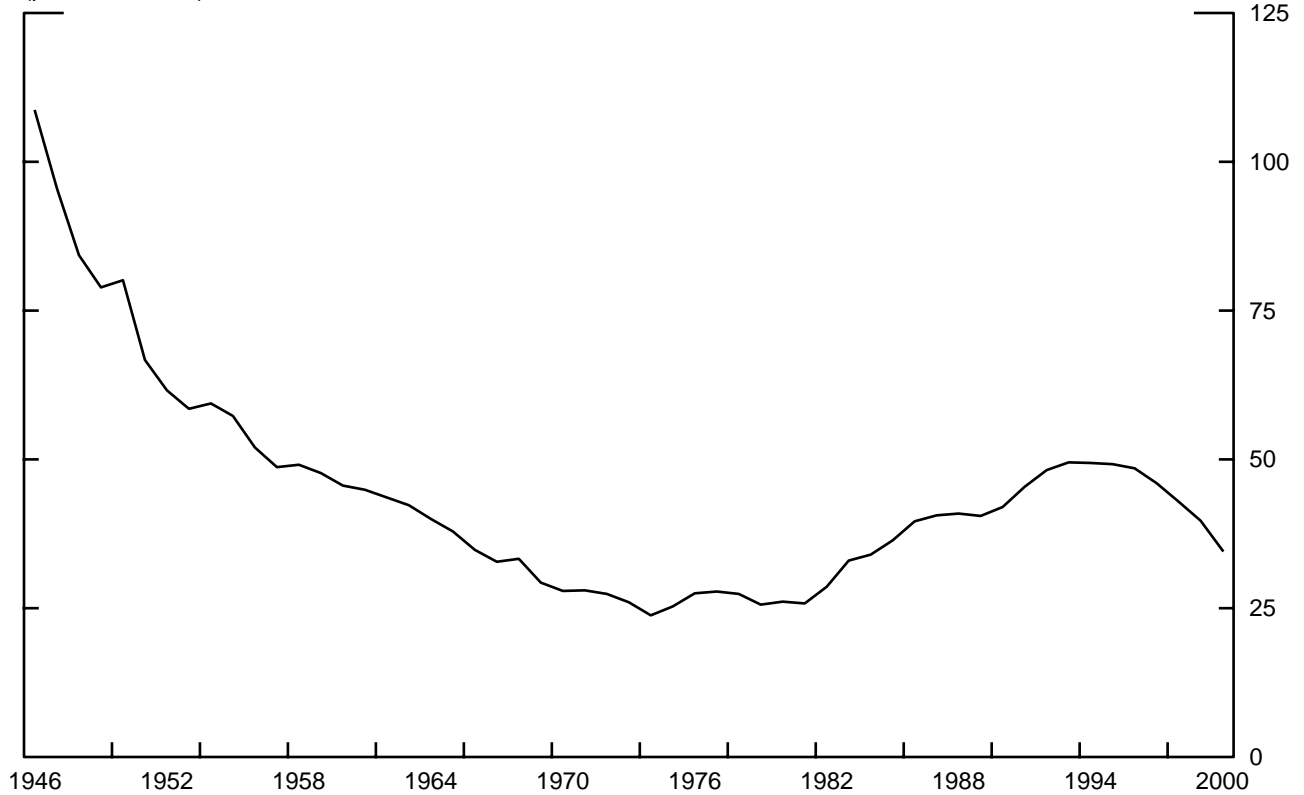


Figure 3: CBO Budget Surplus Projections

(billions of dollars, projections as of January of year shown)

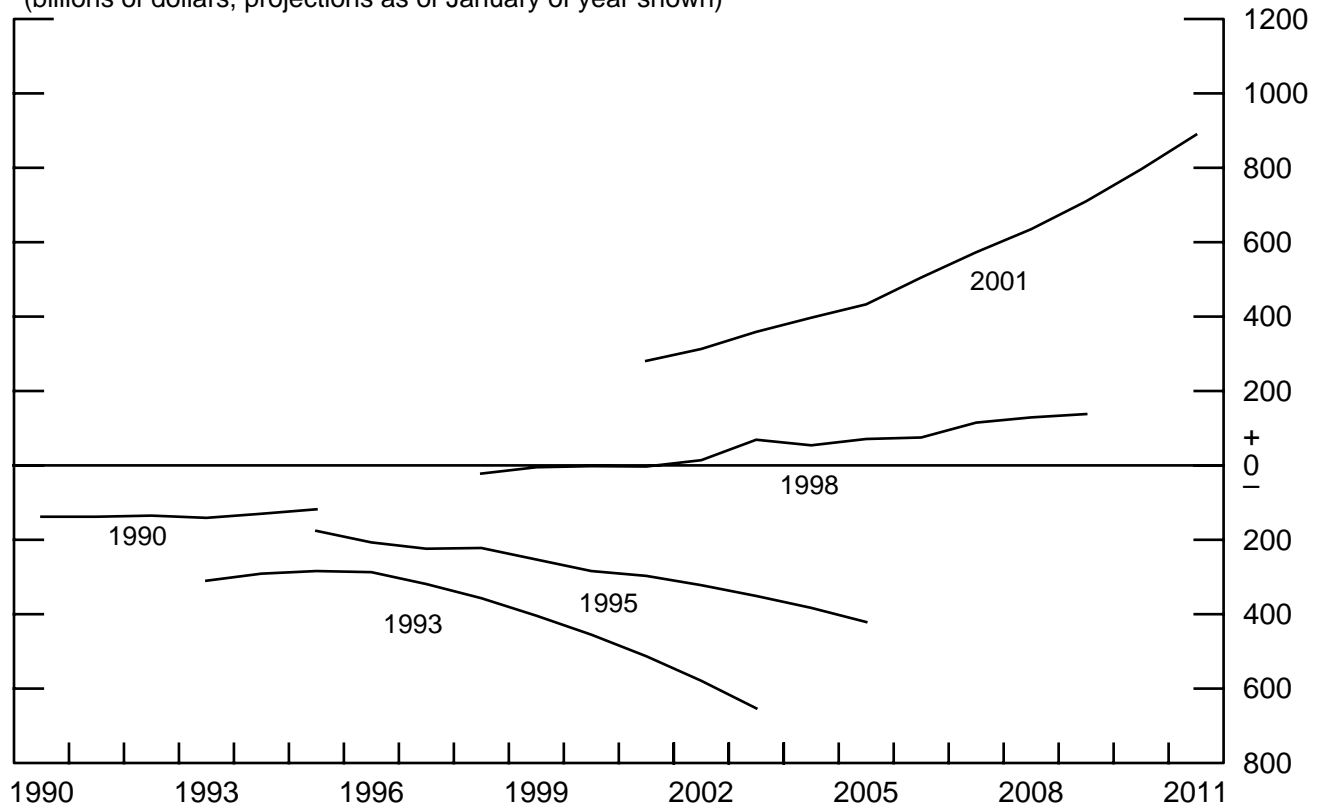


Figure 4: Revisions to CBO Surplus Projections Between 1993 and 2001

(billions of dollars)

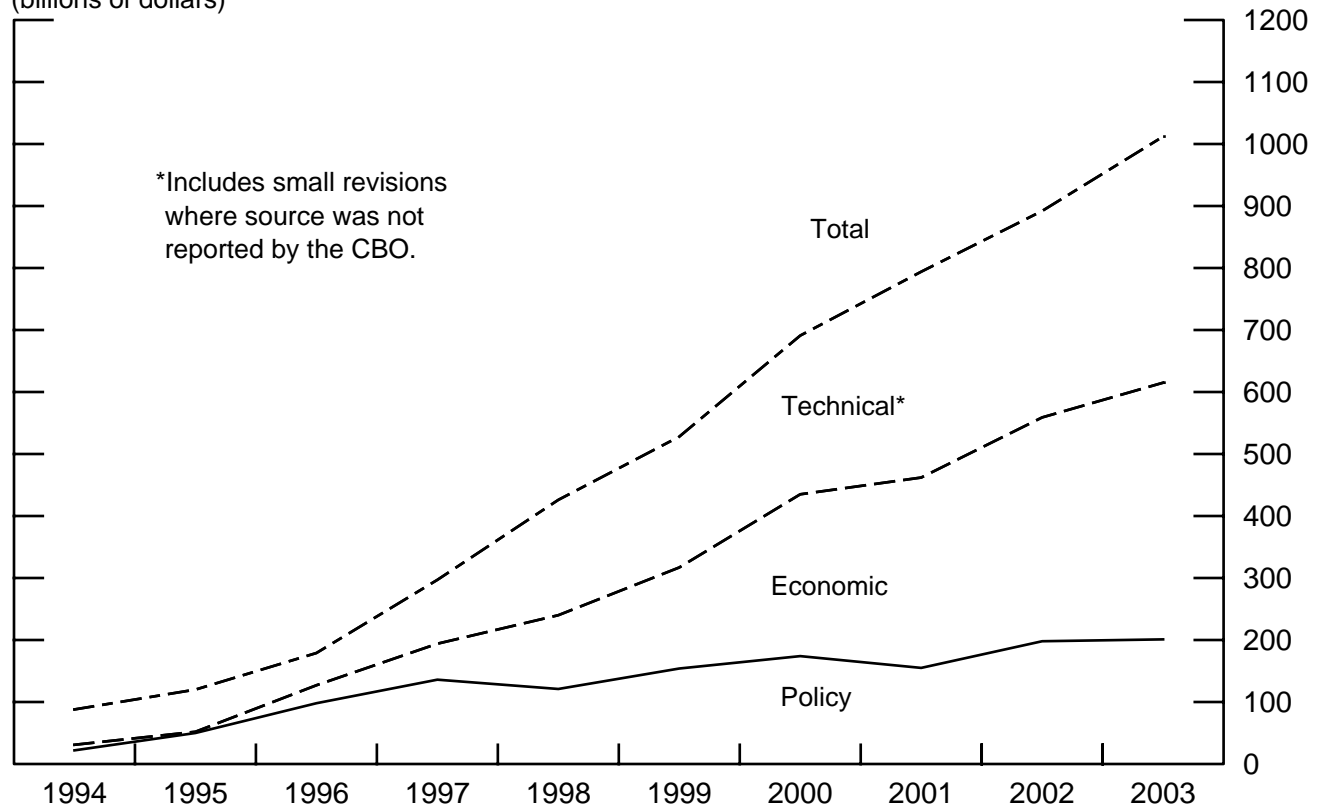


Figure 5: Net National Saving and its Components
(percent of GDP)

