Fiscal Policy and Social Security Policy During the 1990s

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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 in the political consensus toward aiming to balance 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 previous decade, 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 U.S. 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 amount to more than $5.5 trillion over the next decade. This radical change 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.

¹ The CBO was too pessimistic about FY1992: the unified deficit that year came in at $290 billion.
The second respect in which the fiscal landscape was transformed during the 1990s is in the presumed goal of fiscal policy. Until the past few years, debate and decisionmaking about the federal budget almost 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 Social Security surpluses essentially was not disputed; virtually everyone assumed that it will 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 sharp changes in Social Security revenues or benefits. Reforms 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 and moved two other ideas to the center of the Social Security debate: individual retirement savings accounts and investment in equities. In the late 1990s, a plethora of
competing reform proposals combined these basic ideas in different ways, but to date no proposal has been 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

Figure 1 plots 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.

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 the tax policy that we discuss later but also because of 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 capital gains from the booming stock market (CBO, 2000). In particular, 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. 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 next 75 years. 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, other 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. Nevertheless, the relative degree of optimism in the projections probably
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. Yet, the latest long-run outlook from the CBO also includes a substantial increase in the projected rate of health spending growth.

It is useful to examine the timing and sources of this improvement. Figure 2 compares budget outcomes to the CBO’s 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. 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). For example, important technical factors in the late 1990s included the unexpected tax revenue from capital gains and much slower growth of federal health spending than in previous years. The CBO usually updates its budget projections three times per year; for each pair of consecutive dates shown in figure 2, we cumulate all of the revisions in each category between those dates. In some cases, the CBO did not decompose the projection revision, so we also end up with an “other” category. These cumulative revisions apply to the five-year or ten-year budget window following the first year in each pair; that is, for the 1993 to 1995 period, we calculate revisions for fiscal years 1994 through 2003.

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; this tends to downplay the true importance of these actions compared with the favorable developments later in the decade. Second, because CBO does not retrospectively estimate policy effects, any interactions between policy and technical or economic factors are allocated to the technical and economic categories rather than to the policy category. 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.

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 For example, the increase in the top income tax rate in 1993 may have raised more revenue than predicted by the CBO because of the increased share of income later received by people in the highest tax brackets.
than causing it to deteriorate substantially.\footnote{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 more consistent with the current treatment of budget windows and so is shown in our table.} Even so, in January 1995, the CBO still projected 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 were complemented by very large gains in both economic and technical factors to produce 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 actually reduced projected surpluses; the most prominent of these was the sharp increase in late 2000 in the discretionary spending caps that had been adopted in BBA97.

A final perspective on the improving fiscal situation during the 1990s is provided by figure 3. This figure decomposes the difference between the CBO’s 1993 projection and the actual outcome (or 2001 projection for years beyond 2000). By showing only the years included in the 1993 projection, this approach avoids the distortions created in table 2 by the shifting budget window. For the years around the turn of the century, policy changes contributed about one-quarter of the total improvement, with the rest about evenly split between economic and technical factors. As discussed earlier, this estimate should probably be seen as a lower bound on the contribution of policy.

In sum, the remarkable improvement in the budget outlook during the 1990s resulted from a combination of favorable factors: an economic boom that surpassed expectations, higher tax revenue than would have been anticipated given overall economic conditions, slower-than-
expected growth in health costs, and policy actions taken and avoided. We turn now to a chronological review of developments in budget and Social Security policy during the decade.


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 declining to zero over several years. When the target proved too difficult to meet in 1987, the target amounts were raised. Thus, when the 1990s began, the size of federal deficits — and the apparent inability of the political process to reduce them — was a central feature 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 Bush’s expressed willingness to increase taxes as part of a broader budget package. 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 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. In two key respects, the plan represented an approach to deficit reduction that differed sharply 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 force legislative action to tighten fiscal policy in response to a slowing economy, which offered important economic and political advantages. On the economic side, the approach avoided procyclical policy actions that would have worsened an economic downturn. And on the political side, it was more credible not to require the Congress to take painful steps precisely when doing so would come at the greatest political cost.

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 of the 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.

*The First Clinton Budget*

When Bill Clinton campaigned for president, he 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).

In February 1993 the Clinton Administration put forward its first budget document, “A
Vision of Change for America.” The President 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.” -- *Vision of Change* cover letter

The Administration described its budget over five years in the following way: First, it 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.  

Woodward (1994) and Reich (1997) provide accounts of the behind-the-scenes development of the Clinton budget, and both sources emphasize the ongoing conflict between the 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 would depress economic activity in the short run but raise saving, investment, 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 would reduce *future short-term* interest rates, and these lower

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5 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.
short-term rates would be capitalized into 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 would depend 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 invoked this line of reasoning to argue 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, this theory was largely untested in 1993, 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 offset the direct contractionary effect of deficit reduction, they tended to view this possibility 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 head 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 $39 billion in new outlays, and only a fraction of that amount was contained in the final legislation. In particular, the proposed infrastructure spending was largely abandoned, although new funding was provided for the Earned Income Tax Credit, Head Start, and WIC.

**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 small 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.\(^6\) Shortly thereafter, the proposed BTU tax also ran into heavy resistance, especially in the critical Senate Finance Committee. In early June, Treasury Secretary 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 very uncertain. Finally, in August, the 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 Gore casting the tie-breaking vote in favor of passage. President Clinton signed this bill into law as OBRA93.

\(^6\) A $4 billion bill extending unemployment compensation, which had been part of the stimulus package, was passed separately.
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 a good case can be made that the fiscal discipline launched by OBRA90 and OBRA93 made an important contribution to the 1990s economic expansion.

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. Figure 4 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 contributed about 7 percent of GDP in additional saving between 1992 and 2000. Between 1992 and 1997, a small decline in saving by households, businesses and state and local governments offset some of the rise in federal saving, but national saving still increased sharply. 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 that decline 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 benefitted 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 to contain inflation: the 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 and in the current account 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.” Moreover, standard economic reasoning does link these phenomena: a decline in domestic saving is likely to encourage inflows of foreign capital, which constitute a capital account surplus that must be matched by a current account deficit. However, there are
many other influences on international capital flows beyond the federal budget deficit. During
the 1990s the strength of the American economy and apparently high expected returns on
investment continued to attract substantial amounts of overseas capital, even as U.S. national
saving increased.

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 in another paper for this conference. 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 the “Contract with
America,” a multi-part platform that Republican candidates for Congress across the country had
campaigned on. 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 also approved a line-item veto, and the Senate followed suit. This legislation would have given presidents the ability to reject specific items in spending bills and some future tax benefits. Despite President Clinton’s support for the legislation, it was abandoned later in the year, when Republicans became more worried about transferring too much power 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, p. 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 close to current-law levels and made small changes in tax policy. Many people believed that President Clinton had won the battle over the shutdown and had staked out the political center as a fiscally disciplined moderate.

*The Balanced Budget Act of 1997*

In early 1997, budget projections implied that, under then-current law, deficits 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 was a contentious process. 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.7

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

7 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.
projected in 1997 that Social Security outlays would rise from 11.2 percent of payroll in 1997 to 19.8 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 2030.8 Generational accounts published in 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.9

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 retirees will fall from 3:1 to 2:1 between 2000 and 2030 (Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Fund, 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.

*Entitlement Commissions*

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8 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.

9 See Auerbach, Goughale 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 benefit measures that would bring Social Security into long-run balance and allow the unified budget deficit to remain at its 1995 level relative to GDP in the long run. In December of 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 Social Security benefits, reducing cost-of-living adjustments and spousal benefits, subjecting more Social Security 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 represent a sampling of the approaches that were generally under consideration at the time for bringing the system into balance. Similarly, the Medicare options included imposing a new monthly premium for beneficiaries and increasing the deductible from $100 to as much as $1200. On taxes, the options included eliminating deductions for state and local taxes and for charitable contributions.
Yet the majority of the Commission voted against the proposals ultimately put forth by Kerrey and Danforth, and Congressional leaders and Administration officials distanced themselves from the Commission’s findings. For example, incoming House speaker Newt Gingrich reacted to the Commission’s 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.”

White House Chief of Staff Leon Panetta stated that the Administration was opposed to any proposal for reducing Social Security spending. Nonetheless, two commission members, Senators Kerrey and Simpson, went on to introduce Social Security reform legislation based on the commission’s work. 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 the spousal benefit. The legislation also permitted 25 percent of the OASDI trust funds 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.

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 requirement in law that an advisory council be empaneled every four years to review the Trustees’ estimates and

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12 Senator Danforth retired from the Senate at the end of 1994.
comment on relevant policy issues. This advisory council was given an unusually 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, 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.

The members of the advisory council came to consensus on three important key issues: first, that there should be substantially more advance funding of Social Security’s long term obligations in order to boost national saving; second, that equity investments should play an important part in Social Security reform; and third, that any admissible plan had not only to bring the system into 75-year balance, but also leave the ratio of the trust fund to following year’s estimated benefit stable at the end of the 75-year period. This was a more stringent criterion for

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

14 Schieber and Shoven (1999) provide a fascinating account of the commission’s deliberations.

15 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.
16 In the final report, the supporters of this plan did not actually recommend equity investments. Instead, they wrote that the plan “envisioned, 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.
contributions of 1.6 percent of covered payroll which it was hoped would represent additional national saving. Individuals would choose how to invest their account balances.

Five council members, led by Sylvester Schieber and Carolyn Weaver, proposed much larger individual accounts. Specifically, they suggested that 5 percentage points of the 12.4 percent 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. 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 necessary to fund the transition to this system.

The Gramlich Commission struggled for an extended period of time to come to consensus around a single plan, but eventually determined that they could not, and 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 been able to come to consensus around a single plan, because its analysis of these three alternatives served as a valuable launching pad for future analysis, including the work of Clinton Administration staff.

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 into the mainstream policy debate.

17Another 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.
Unlike the first two commissions, the Center for Strategic and International Studies’s National Commission on Retirement Policy (NCRP) was not a government commission, although its co-chairs Senators Gregg and Breaux and Congressmen Kolbe and Stenholm were committed to introducing the commission’s ultimate recommendations in legislation. The group was launched in January of 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 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 increase from 20 to 40, so a household headed by a worker with 40 years of earnings would never fall below the official poverty line.\(^\text{18}\)

Despite the growing awareness over this period that current fiscal policy was not sustainable in the long run, none of these proposals came close to being enacted, partly because the need to reform a system that was projected to remain solvent for another 30 years paled in comparison to the urgency of addressing the near-term fiscal deficits.

\(^{18}\) 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.
Turning to Social Security Reform in the Clinton Administration

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 a strategy for shaping this commission. Most importantly, the Administration was projecting unified budget surpluses of roughly $600 billion between 2002 and 2007. Because these surpluses fell within the ten-year budget window, the Administration would need 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 the one hand, the availability of surpluses gave the Administration the freedom to contemplate new ambitious goals. On the other hand, for five years President Clinton had successfully headed off Republican calls for deep tax cuts 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 we should have been saving more to prepare for the retirement of the baby-boom generation.

The Administration’s economic team met throughout the summer and fall of 1997 to consider possible 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 at that time. These advisers believed that the Medicare challenge was too great because the program combines Social Security’s demographic challenges with the additional issue of rising health costs per beneficiary. 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, there was significant concern that once the President opened the door to a major tax bill, the Administration would lose control of the process to Congress and a flat-tax plan with significant revenue loss (and therefore a negative effect on national saving) and adverse distributional consequences would become the focus of the debate. Second, it seemed likely that any reform that made progress on substantive goals such as simplifying the tax code or encouraging saving would create millions of losers as well as millions of winners, even with the commitment of substantial surplus funds. Moreover, no particular 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 fact that the Gramlich Commission was seen as having set out a number of plausible paths to long-run solutions 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 enthusiasm also stemmed from the view that
using the surpluses for Social Security reform was more likely than the other alternatives to prevent a tax cut or other new spending. Thus, reforming Social Security could lock in President Clinton’s most important economic accomplishment and permit the projected surpluses to feed through into national saving. Indeed, the economic team believed that even if 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 goal of increasing national saving was central to the Administration’s thinking about Social Security reform. Although conventional wisdom certainly indicates that the nation should save more now in preparation for the retirement of the baby-boom generation, the economic case for that position is less clear cut than one might think. The fundamental issue is whether current generations should give up consumption in order to increase the well-being of future generations. In the absence of population aging, determining the optimal rate 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 optimal. Second, the slowdown in population growth will increase the capital-
labor ratio; in turn, the increase in the capital-labor ratio will reduce the return to saving (Cutler et al., 1990). Other things equal, a lower return would suggest the optimality of engaging in less saving. Using simulations that quantify these effects, Elmendorf and Sheiner (2000) conclude that the United States probably should not undertake substantial additional saving in response to the anticipated demographic shock. A third consideration is that, according to currently available projections, tax rates would have to rise very significantly over time to fund current-law benefits on a pay-as-you-go basis. For example, the Social Security payroll tax rate would have to rise from its current level of 12.4 percent (combined employer plus employee) to about 18 percent – an increase of roughly half. Since deadweight loss is thought to rise non-linearly with the tax rate, this logic suggests that economic efficiency might be substantially increased by raising taxes on current workers in order to decrease the required future tax rates.

Although there is no consensus about the optimal saving rate, many economists believe that a number of factors are causing the current U.S. national saving rate 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 make the social return to saving exceed the private return.

That said, it is very difficult to predict whether a given Social Security reform plan will actually boost national saving. If budget policy in the non-Social Security part of the budget responds to Social Security reform, then the direct impact of reform on national saving can be partially or fully offset. For example, if budget policy is made with the aim of balancing the
unified budget, any increase in Social Security surpluses may simply result 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 impact on national saving of seven different approaches to Social Security reform and show that these impacts depend heavily on assumptions about how households and the rest of the budget respond to Social Security reform.

The Administration’s economic team was also aware of a significant group within the Democratic Party that downplayed the need for reform, partly as a strategy to prevent radical change in Social Security. This faction emphasized that under the Social Security Trustees’ low-cost assumptions, the system remains solvent throughout the 75-year projection period. In light of the possibility that the system might be viable, they argued it would be foolhardy to open up 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 simultaneously turn out substantially better than expected. The probability of this happening was thought to be very low. Second, recent research by academic demographers (for example, see Lee and Tuljapurkar (1998)) suggested that U.S. longevity would likely increase more rapidly than projected by the Social Security Trustees, and therefore that the costs of the program would be higher. Thus, the distribution of possible outcomes seemed weighted toward a worse not a better financial situation than projected by the Trustees.
A similar point was sometimes made about economic growth, with some observers noting 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. This argument missed the point that the growth of the labor force will likely slow from its current pace of about 1 percent per year to approximately 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 the 1.5 percent per year 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. In addition, because a retiree’s initial level of Social Security benefits is indexed to aggregate wage growth during his or her working years, faster economic growth has limited ability to improve Social Security’s finances in the long run. It is only because benefits after retirement are indexed to inflation rather than wages that economic growth improves the actuarial standing of the system.

“Saving Social Security First”

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

19 The numbers in this paragraph are taken from the 2001 Trustees’ Report.
engaging the Republican leadership in high level negotiations in the Spring of 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 second 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. However, the Administration viewed the second proposal as a simpler message and as offering a way to avoid the risk that the President’s specific proposal would serve simply as a lightening rod for criticism and end up reducing the chance of achieving Social Security 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 policy did not mean that the entire projected surplus would necessarily be allocated to Social Security reform, but rather that the President would not support other uses of the surplus – either for net tax cuts or net spending increases – until reform was accomplished and it became clear how much of the surplus was needed to finance that reform. Thus, this policy was intended both to preserve the projected surpluses in case they were needed to fund the transition to a more fully funded Social Security system, and to provide a reward – the ability to spend the surpluses – as an incentive to Congress for tackling Social Security reform.
President Clinton also announced a year-long process of national dialogue including bipartisan Social Security forums designed to educate the public that would culminate in a December 1998 White House Conference on Social Security. At the first of these forums, in Kansas City, the President laid out 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 options, and proposals that would adversely affect low income beneficiaries. The President also made clear at this conference that all reform options other than an increase in the payroll tax rate should be on the table. Throughout the year of dialogue, President Clinton accepted the advice of his economic team and did not rule out an eventual increase in the normal retirement age. The President 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.20

5. Social Security Reform Options

20As a further step toward providing cover for constructive dialogue about Social Security reform, the Administration adopted the public position that it would not comment on individual elements of a possible reform plan in isolation, but rather would need to evaluate “whole plans.” This approach served to keep even painful reform options on the table, while preserving room down the road to score complete reform proposals against the principals the President had laid out.
After the 1998 State of the Union, the Administration began a systematic process to develop a Social Security reform plan. A working group jointly chaired by National Economic Council Chair Gene Sperling and Deputy Treasury Secretary Larry 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 meetings with the President roughly once every six weeks. The working group studied a wide range of options including many that were unlikely to be supported by the Administration so as to be prepared for the debate that was expected to arise.

The working group studied analytical issues that cut across the various reform options and then constructed specific alternative reform plans (again, including many the Administration probably could not have supported). Most of the analysis focused on issues related to 1) ways of using the projected budget surpluses as part of Social Security reform and 2) mechanisms for pre-funding Social Security benefits that relied on investment in private financial assets. The plan construction focused on approaches to Social Security reform that could bridge the gap between defenders of the current defined benefit system and proponents of individual investment accounts. In particular, a good deal of the group’s work was directed toward constructing various hybrid plans that had features of both approaches.

Relatively little time was spent analyzing traditional reform options such as raising the retirement age, adjusting the consumer price index, or changing the tax status of Social Security benefits. In part, this relative lack of attention to traditional reform mechanisms reflected the familiarity of those approaches. They had been studied at great length, for example, by the Gramlich Commission (the final report of which included an extensive table showing the impact
on the 75-year balance of a wide range of reform options). What was new in the current situation was the availability of additional resources, in the form of the emerging surpluses, that might be used to reduce the pain of putting the system on a sound footing. In part, the relative lack of attention to traditional reform mechanisms also was a time management decision – it did not make much sense to focus on the specific revenue raisers and benefit cuts until the President settled on a particular approach to reform. In addition, there were good political reasons for why the group should not devote much of its early efforts to traditional reform mechanisms. As a matter of strategy, the Administration believed that the specific “pain” elements of a Social Security deal would have to be introduced at the last minute as part of the final bipartisan negotiations with Congress that produced a deal. The view was that if anyone proposed specific pain options before a complete bipartisan deal was reached, others would attack the options, and important responsible policies would be taken off the table prematurely.

**Using Projected Budget Surpluses as Part of Social Security Reform**

There were two challenges in attempting to use current budget surpluses to help pay future Social Security benefits. The first was how to set aside the money today in a way that would in fact boost the resources available to future generations (rather than having the funds be dissipated down the road by future Presidents and Congresses), and the second was how to ensure that 30 or 40 years from now these incremental funds would be used specifically to fund retirement benefits.

Using the surplus to pay down the federal debt was seen as the most direct way to boost national saving and increase the resources available to future generations, but by itself this
approach had several shortcomings. First, it was not obvious how to give Social Security a claim on the additional future resources that would be made available by paying down the debt. Second, following this strategy would result in the entire publicly held debt being paid off long before the unified surpluses were projected to run out, raising the question of how the ensuing “national asset” should be invested. Third, it was hard to see how this strategy could be locked in for the long-term. If at any point in the future a President and Congress were elected who decided to use the surplus for a tax cut or new spending instead, then these resources would not be available as planned.

These concerns led the Social Security working group to devise a series of reform plans that involved transferring the unified budget surplus to the Social Security trust fund. These plans took the surpluses “off the table” so that they would not be used for purposes other than debt reduction, gave the Social Security system a legal entitlement to the future resources created by this policy, and ensured that any later diversion of the surpluses to other purposes would have a large adverse implication on the Social Security trust fund.

The downside of these plans was that they could be attacked as “double counting” the Social Security surplus and required novel budget accounting in order to work. With regard to the issue of “double counting,” the view of the economic team was that if transferring a dollar of the unified budget surplus to the trust fund permitted an extra dollar of publicly held debt to be paid down it was legitimate to credit this dollar to Social Security. In particular, at this time the budget process was focused on balancing the unified budget so there was good reason to believe

\[ \text{See Penner (1998) for a discussion of budget scoring issues that arise in Social Security reform plans.} \]
that any unified budget surplus left unallocated would be at risk of being spent or used for a tax cut. Thus, in a very real sense, every dollar of the unified surplus that was instead used to pay down debt was new national saving and could legitimately be credited to the trust fund. This plan had “bad optics,” however, since much of the unified budget surplus originated in the Social Security surplus. Thus the same dollar of revenue had already been credited to the Social Security trust fund once, and people could charge that it was double counting to transfer it again. The Administration was well aware of this potential criticism, and indeed the issue was first discussed with the President in mid-1997, fully 18 months before the President’s Social Security plan was released. Internally, a number of economists argued vigorously against adopting a plan with this feature. However, the obvious alternative – taking Social Security out of the budget and transferring only on-budget surpluses (which did not originate in Social Security and were not subject to the double counting critique) to the trust fund – was not an option at this point because it would have imposed too much fiscal stringency, and it would have required the Administration to give up talking about its proudest accomplishment, the unified budget surplus and instead report an on-budget deficit.

Surplus transfers raised a second accounting issue as well. Under conventional scoring, a dollar transferred from the on-budget account to the Social Security trust fund would not reduce the unified budget. Thus it would not accomplish the goal of taking the dollar off the table. In other words, the dollar could be credited to the Social Security trust fund a second time and not

22 Clinton White House-speak for “did not look good.”

23 Of course the status quo involved the same sort of double counting – dollars were credited to the trust fund and then used for new spending or tax cuts.
result in any debt being paid down if it were still viewed as available for tax cuts or increases in spending. Therefore, in order to accomplish the Administration’s goal it was necessary to invent a new budget accounting rule that any dollar transferred from the unified budget surplus to the OASDI trust fund would result in a one dollar reduction in the reported unified budget surplus.

*Investments in Private Financial Assets*

Beginning with the Gramlich Commission, nearly all Social Security reform proposals being considered in the debate involved some investments in private financial assets. This consensus, however, left a wide gap between those favoring individual accounts and those favoring collective investing on behalf of the Social Security trust fund. The pros and cons of these two approaches received a substantial amount of analysis by academic economists in the mid 1990s with Henry Aaron, Peter Diamond, and Robert Reischauer emphasizing the high administrative costs and portfolio risk associated with individual accounts, and devising mechanisms to protect collective investment systems from political interference. On the other side, Martin Feldstein, Andrew Samwick and their coauthors wrote a series of papers illustrating how the U.S. could make the transition to a partially or fully-funded Social Security system based on individual accounts. The analysis conducted within the Administration built upon this academic work and extended it significantly along several dimensions, focusing primarily on four issues: administrative feasibility and cost, risk, political interference in markets and corporate governance, and redistribution.

*Administrative Feasibility and Costs*
Research by Peter Diamond had shown that administering individual accounts had been expensive in Chile and the UK and suggested that costs might similarly be high in the United States (Diamond 1996, 1997, 2000). In particular, he pointed out that with annual costs of 100 basis points – similar to many U.S. mutual funds today – an individual would lose around 20 percent of his or her retirement income to administrative costs. As the technical working group began analyzing individual accounts, then Deputy Secretary Summers insisted that the working group begin by determining whether it was even remotely feasible to set up such a system, what kind of service it could provide, and at what cost.

The information technology staff at Treasury and the Social Security Administration were tasked with determining exactly how information and dollars would flow from workers’ earnings statements to private investment managers. Extremely detailed estimates were produced for how much additional manpower would be necessary for such a system to function. For example, one option was for workers to indicate their choice of a private sector fund manager on their 1040 tax form. The working group’s estimates were at the level of detail that it was determined how many digits an ID number would have to be for each fund and how many key strokes would therefore be required to enter all of the ID numbers each year. Separate estimates of cost and manpower requirements 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 key 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 are used to in the 401(k) plans offered by their employers. From a political standpoint, it was considered important 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 dealing with preparations for the Y2K bug, so it did not seem possible that substantial resources could be devoted to setting up a system of individual accounts until after those preparations were completed. At one point in mid 1998, serious consideration was given to starting the process of setting up the administrative structure for the accounts right away, a year before there was any chance of a full plan being enacted by Congress, so as to shave a year off of the time between enactment and having accounts set up.

In considering whether the system would be perceived as providing an adequate level of service, a major concern of the working group was whether contributions could be made to the accounts in a timely manner. Employers do not report the annual earnings of their workers until the first quarter of the year after that in which the earnings occurred. It then takes the IRS several months to process and reconcile these earnings records, so that it is typically August before a mostly complete set of earnings records for the previous year is available. The working group thought it would be unattractive to have account contributions made as much as 18 months after the earnings occurred on which they were based. Options were developed that involved making estimated contributions to people’s accounts based on their previous year’s earnings as well as investing all of the account balances in a default portfolio and then allocating the funds to individual accounts (including the within-year returns) once the information on each worker’s earnings was available. Even recognizing the scope for creative approaches like this one, there was serious concern that any feasible, inexpensive individual account system would be perceived as providing inferior service compared with what people were accustomed to; Deputy Secretary
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 it would be feasible to set up individual accounts, but that only bare-boned accounts could be administered at a reasonable cost. Thus, the costs of millions of small accounts would have to be minimized by not allowing people any investment choice until their accounts reached a minimum size (perhaps $5000); until then the funds would be invested collectively. The number of investment choices would need to be limited to perhaps a dozen firms offering broad-based index funds. Mailing of account statements would be at most once a year, and phone inquiries would not be toll-free. Importantly, borrowing against the balance in the account would be prohibited, not only in order to preserve the account balance exclusively for retirement use, but also because the private-sector experience has been that administering loans is very costly. The working group determined that nearly all of the costs of such a system could be thought of as essentially fixed dollar amounts, and the group’s best estimate was that such a system could be run at an annual cost of $20 to $30 per account. Accounts with service that approached that in current 401(k)s would be two or three times as expensive. Notwithstanding that the true cost structure essentially involved fixed dollar amounts per account, the group believed that the costs should be spread across all accounts in proportion to their assets so as not to burden lower-income people who had small account balances.

Risk

Social Security reform plans that involve investment in equities could potentially introduce two new sources of risk into the system. First, aggregate stock market fluctuations
could leave different cohorts with much higher-than-expected or lower-than-expected levels of retirement income. Second, to the extent that individuals within a cohort were permitted to make individual investment choices, their retirement incomes could vary based on these choices. The extent of this risk varied considerably across different approaches to Social Security reform. Collective investment by the trust fund would certainly allow these risks to be smoothed within generations and, to the extent that there is at least some mean reversion in equity prices, across generations as well. At the other extreme, individual accounts with IRA-style investment options could result in substantial numbers of ill-informed investors taking on either too much or too little risk in their investment portfolios, and opening up the possibility that a system of individual accounts might create millions of new “notch babies.” (Two individuals born in the same year or nearly the same year, with identical earnings histories, might retire with very different Social Security benefits, either because they assumed different idiosyncratic risks in their portfolio choices, or because aggregate fluctuations in the stock market had affected them differently.)

Treasury Secretary Rubin was particularly concerned about adding market risk to the Social Security system and argued that it would be a mistake to have Social Security benefits depend on market returns, whether it was the trust fund or individuals doing the investing. He worried that the boom in the stock market then under way 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?”

Partly in response to Secretary Rubin’s concerns, a large portion of a meeting with the President in July 1998 was spent reviewing reasons to be cautious about equity investments and comparing the risk under different reform proposals. The President was reminded that the S&P
500, even including reinvested dividends, did not regain its 1968 value in real terms until 1983, that Japan’s Nikkei index had fallen by 60 percent since 1989, and that simple economic models have trouble explaining why the rate of return on stocks over the twentieth century has been so much higher than the return on bonds, raising concerns about whether this gap will persist in the future. Concerns were also raised about workers during the transition to a new individual account system who would not have a full 40 years of market exposure. Even if stocks were to perform better than government bonds over nearly all 40-year periods, workers during the transition might experience a subperiod during which stocks did relatively poorly.

Overall, however, the economic team did not think that market risk was a sufficiently important concern to rule out plans that involved equities. First, the historic evidence suggested that in the United States even large stock market declines have ultimately been more than made up for in subsequent rebounds. For example, the portfolio of a worker who lived through the 1929 crash – when the S&P 500 lost 85 percent of its value between September 1929 and June 1932 – would have fully recovered by the end of 1936. Second, under the reform plans the Administration was considering, only a relatively small portion of retirement benefits would be exposed to market risk. (Correspondingly, of course, these plan only benefitted to a limit degree from the exposure to equity risk.) Third, while equity valuations were then very high relative to historic levels, a correction that occurred in the next decade or so would be relatively unimportant for retirement benefits since relatively little would have been accumulated by then in the trust fund or in individual accounts. Fourth, under all of the plans under consideration by the Administration, the 12.4 percent of payroll OASDI tax would still be directed to a defined benefit free of market risk. Thus, even in the unimaginable circumstance in which all of the stock
investments became worthless (in which case, the solvency of the Social Security system would probably not be first on the list of the country’s problems!). Social Security would still be in the same position that it would be if we did nothing today to prefund future benefits. Fifth, the current Social Security system has its own forms of risk, including the political risk that benefit rules will change, the demographic risk that forecasts of mortality and fertility trends will turn out to be incorrect, and the economic risk that productivity growth will be higher or lower than currently forecast. Thus, even though there is little or no investment risk in the current system, there are uncertainties about various factors that will bear on the viability of the system and the extent to which benefits will need to be trimmed or taxes raised in the future. While introducing equities into the system might introduce a new form of risk, and might even increase the amount of risk overall, it would not convert a currently riskless system into a risky one. Instead the system would be moving along a continuum of risk.

Ultimately, the economic team was nearly as concerned about perceptions of risk and how individuals and the political system would react to risk as it was about actual risk. For example, if an individual reached retirement and mandatory annuitization with an account balance that was below a previous peak level, the retiree might feel that he or she had fared poorly even if the retiree had done better over his or her lifetime being invested in equities than in government bonds. As noted earlier, if the market fell substantially just before a worker retired and annuitized his or her individual account, he or she might feel that it was unfair that workers who retired one year earlier received higher retirement incomes. Moreover in a system of individual accounts, individuals might shift out of equities after a market decline, missing the recovery. If the trust fund were invested in equities, there might not be sufficient political
There was some concern within the working group that guarantees could induce people to take too much risk in their portfolios or would result in a large budgetary obligation for the government.

Political Interference in Markets and Corporate Governance

Although centralized investment in equities was thought to have important advantages, it was also seen as having two significant disadvantages. The first was that trust fund investments lacked the features that made individual investments so politically attractive: the perception of wealth creation for all Americans, individual choice, and bequest possibilities. The second was that ownership of private financial assets by a government trust fund raises significant issues of corporate governance and political interference in markets.

Under Social Security reform proposals from Robert Ball and from Henry Aaron and Robert Reischauer, as much as 50 percent of the Social Security trust fund would be invested in equities. This would be a very large share of the U.S. stock market, somewhere between 15 and 30 percent of the stock market in 2030, depending on the relative growth rates of GDP and the stock market. Even with smaller fractions of the trust fund invested in stocks, the government could end up as the largest single shareholder of many companies. These large ownership levels mean that if political considerations influenced the manner in which the Trust Funds were

24 There was some concern within the working group that guarantees could induce people to take too much risk in their portfolios or would result in a large budgetary obligation for the government.
invested, the efficiency of U.S. 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 more than enough to give one pause on this issue; it is not difficult to compile a sobering list of vivid examples in which political intrusion had materially reduced investment returns and arguably reduced the efficiency of various economies.

In addition to political pressures on investment decisions, collective investing raises questions about how the government would exercise its rights as a shareholder to choose corporations’ managers and influence 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. Moreover, at least for a private investor, voting rights are an important source of value in owning equity. Would the government adequately be fulfilling its fiduciary responsibilities if it simply ignored that source of value altogether? Lastly, trust fund investments could constrain economic policy making, discouraging economic policies that lowered stock prices. For example, if the government were a major stockholder in Corporation XYZ would the Justice Department be discouraged from pursuing a meritorious anti-trust case against XYZ? Would the EPA shy away from enforcing anti-pollution regulations against XYZ? Would OSHA refrain from inspecting it for safety violations?

To a greater degree than most observers seem to appreciate, many of these same issues would arise under a system of individual accounts if the system were centrally administered and investors were limited to a small number of investment vehicles. Indeed, most legislation
proposing individual accounts would put strict limits on investment choices. To the extent that Congress was setting the rules for these investments, political interference issues could potentially be just as severe here. On the other hand, Congress may feel more constrained about how it restricts the investment choices of individual investors than it would for a government trust fund, and individuals may arguably be more vigilant in policing departures from strictly neutral investment policies if their own names are attached to particular accounts.

Some members of the economic team, heavily influenced by the ideas of Diamond, Aaron, and Reischauer, felt that these problems were not insurmountable. Some members pointed to the fact that many pension plans for government workers, particularly those like the Federal Thrift Savings Plan that are defined-contribution plans, have existed for years without political interference. The more optimistic members of the team believed that the interference and governance problems could be addressed by insisting that the enabling legislation set up an independent board modeled after the Federal Reserve Board, with members from the private sector charged with acting in the sole interest of the beneficiaries of the trust fund. The range of investment options could be limited in the enabling legislation to widely used index funds. (The requirement that only “widely used” funds be used was thought to be a defense against an effort to require that Social Security funds be invested in an equity index that included, say, all publicly traded firms in the U.S. except those who engaged in some specified out-of-favor activity.) The fund managers could be required to co-mingle the money they received from the government.

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25 For example, the Archer-Shaw proposal discussed below required all investments to be in index funds with exactly 60 percent stock 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.
with the money they were managing on behalf of their private clients. The enabling legislation could require that private equity managers be chosen on the basis of a competitive process, and that they vote the proxies on behalf of the beneficiaries. Since Congress could at any time pass a law altering any of the safeguards, it would be important that a culture of non-interference develop around the independent board from the beginning.

Redistribution

An important principle for the Administration was that Social Security reform should not reduce the amount of redistribution from high-income to low-income households that occurs through Social Security. Similarly, it was important that reform not reduce the incomes or add excessive risk to the incomes of demographic groups such as elderly widowed, divorced, and never-married women that depend the most on Social Security to keep them out of poverty in old age. Gene Sperling believed that at the start of any negotiations with Republicans in Congress, the President should state that he would only consider individual account plans that made the Social Security system more progressive than it currently is.

Since the most commonly proposed way of funding individual accounts – making contributions to accounts that were proportional to an individual’s earnings (2 percent of earnings for example) – would not provide any redistribution to lower-income workers (indeed with mandatory annuitization at a single price such a system would redistribute from poor to rich since the rich live longer), the technical working group studied other options for funding accounts that
One option was to use the budget surplus to fund equal dollar contributions to the account of every worker. Contributions of $300 per worker had about the same aggregate cost as contributions of one percent of payroll. Thus $600 per worker contributions would be a highly redistributive alternative to 2 percent of payroll accounts. Our analysis indicated that accounts with an equal $300 contribution per worker plus a 1 percent of earnings contribution would come very close to replicating the redistribution in the current Social Security system. In April 1998, Speaker Gingrich had 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.

An alternative to funding the individual accounts in a redistributive manner would be to make the traditional system more redistributive at the same time non-redistributive individual accounts were introduced, as was done in the Breaux-Gregg-Kolbe-Stenholm legislation. The economic team had great concerns about this approach since it would lower (from already very low levels) the rates of return received by higher income people from the traditional system, and thus run the risk of further eroding support for a universal program.

26 Even accounts funded proportional to earnings can be redistributive if the source of the funding is a progressive source such as the federal personal income tax.

27 See Feldstein and Liebman (2001) and Liebman (2001) for further discussion of these issues.

28 There are, of course, many other formulas that one could use to make redistributive contributions to individual accounts. For example, the government could contribute 10 percent of the first few thousand dollars of earnings, 5 percent of the next few thousand dollars and a smaller percentage on additional earnings.
The working group was however, quite interested in adjusting benefit formulas in the current system to lower rates of poverty among elderly women. Poverty rates among elderly women who are divorced, widowed, or never married are currently around 20 percent – roughly twice the population-wide average. The NEC coordinated an inter-agency process to develop options for lowering this rate, and produced a report that was issued in conjunction with a Presidential event on the importance of Social Security to women.\textsuperscript{29} Options for improving the benefits paid to women included increasing SSI benefits, providing Social Security earnings credits for years out of the labor force raising children,\textsuperscript{30} and providing a new widow benefit at 75 percent of the benefit the married couple was receiving before the deceased spouse passed away (capped at the benefit received by a worker with average earnings). These proposals 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 never proposed by President Clinton, versions of these proposals were put forth by Vice President Gore during his Presidential campaign.

Another important concern was to make sure that Social Security reform did not reduce the income levels of recipients of Social Security disability benefits. Because the benefit formulas for retirement benefits and disability benefits are linked, cuts to retirement benefits would typically carry through as reduced disability benefits as well. This is an important issue


\textsuperscript{30}This was a more progressive version of the traditional proposal to provide drop-out years in the social security benefit formula. Earnings credits values the time out of the labor force raising children at the same level regardless of a woman’s earnings level. Drop out years implicitly value time out of the labor force of high earning women at a higher rate than low earnings women.
for individual account plans because many disabled beneficiaries under many plans would not
have accumulated significant account balances by the time they are disabled; therefore they could
not make up for cuts to the traditional benefit with the proceeds of their individual accounts in
the same way that non-disabled workers could. The working group believed that any cuts to the
traditional benefit should not be applied to disability benefits and all of the reform plans the
group constructed were scored under this assumption.

**Designing Reform Proposals to Bridge the Gap**

The working group believed that although the political challenge of achieving Social
Security reform was immense, there was much more potential for a consensus on substantive
grounds than the heated rhetoric on the issue might indicate. In particular, on the two most
contentious issues, whether investments should be handled collectively or left to individuals and
whether individual accounts should be outside of Social Security or part of Social Security, there
was a virtual continuum of options, and proposals from the left and right seemed to be
converging in the middle.

Early in the debate, proponents of individual accounts were arguing that there should be
no restrictions on investment options. For example, Martin Feldstein initially proposed that
individual accounts be administered by letting people invest in the same broad set of investment
options that are available to holders of IRAs, and that funding for these accounts be handled
through a tax credit. But in response to concerns about administrative costs and naive investors,
most Republican plans (including the main legislative proposals) ended up restricting investment
choices to a few broad indexed funds similar to the choices offered under the Federal Thrift
Savings Plan. Similarly, early plans for trust fund investments 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 sector investment managers. Thus by the middle of 1998, the investment mechanisms being proposed by both those on the right and those on the left were coming together.

A similar convergence was occurring on whether individual accounts should be part of Social Security and on what the source of funding for the accounts would be. Many liberal Democrats who opposed individual accounts as part of Social Security were willing to consider providing government subsidized pensions targeted at low-income households. Some Republicans who initially favored diverting a portion of the 12.4 percent OASDI to individual accounts and cutting the traditional benefit substantially, started proposing add-on plans in which new money outside of the 12.4 percent was used to fund the individual accounts. (Some of these plans were presented as carveouts in which general revenues were used to replace the money diverted from the Trust Fund to individual accounts.) Some of the Republican proposals involved redistributive funding of the individual accounts, and some even effectively made the Social Security trust fund the ultimate beneficiary of the accumulated investment balances. Thus, there similarly seemed to be a potential convergence of the policy debate around using additional non-Social Security funds to make redistributive contributions to individual accounts and possibly to make investments to shore up the Social Security trust fund as well.

Within this narrowing policy space in which there appeared to be the potential for a bipartisan deal, there were three main types of Social Security reform plans. The first and
The clawback can also be specified as a reduction in Social Security benefits equal to some fraction of the account withdrawals. For example, a worker might lose 75 cents of Social Security benefit for each dollar of retirement income from an individual account.

The simplest were add-on individual account proposals like the one Gramlich put forward in his Commission’s report. These plans involved continuing to allocate the entire 12.4 percent payroll tax exclusively to fund the traditional defined benefit Social Security benefit, and using traditional benefit cuts and revenue options to bring the defined benefit system into balance. Then individual accounts typically funded with additional resources (from the budget surplus or additional mandatory contribution) equal to 2 percent of payroll would be added on top of the reduced traditional benefit to make up the difference.

The second set of plans were clawback plans. The idea for these plans came from a paper by Martin Feldstein and Andrew Samwick. Individual accounts would be funded out of the budget surplus and then, when workers reached retirement, 75 percent or more of the account balances would be used (“clawed back”) to fund traditional Social Security benefits, leaving the individual to consume the remaining 25 percent (or less) of the account proceeds. Thus, this plan is basically a back-door way for the Social Security trust fund to invest in equities, but in a way that allows individuals rather than the government to control the investment choices. Congressmen Archer and Shaw introduced a plan of this form.

The third set of plans were “hybrid plans” that involved both trust fund investments in equities and the establishment of individual accounts. Some people saw these plans as splitting the difference between the two sides in the debate, while others argued that because the costs of administering individual accounts are largely fixed costs, the administrative costs of the smaller individual accounts that were likely to be a part of a hybrid plan would consume an excessive

31 The clawback can also be specified as a reduction in Social Security benefits equal to some fraction of the account withdrawals. For example, a worker might lose 75 cents of Social Security benefit for each dollar of retirement income from an individual account.
fraction of the investment returns. Besides the obvious political appeal of a plan that gave each side what it wanted, this approach offered interesting opportunities to counter the concerns about government interference in markets and corporate governance. In particular, the trust fund investments could simply mirror the investment choices that individuals made in their individual accounts. This could be done in the aggregate through a single fund or one could actually set up individual “mirror accounts” in the name of each worker that were invested on behalf of the trust fund.

On substantive grounds it was possible to design plans through any of these approaches to reach essentially the same goals on benefit levels, risk, and redistribution. Thus, discussions within the Administration over which policy to pursue centered on which had the best chance of leading to a bipartisan deal and over the relative “slippery slope risk” of each plan. In particular, the economic team was extremely concerned that a Social Security reform plan involving modest individual accounts might lead to total privatization in the long run. There was considerable disagreement within the economic team over which plan had the greatest such risk. Some members of the team argued that the clawback approach would do the most to preserve the existing system, since nearly all of the revenues would continue to be paid out through the traditional defined benefit formula. Other members strongly opposed the clawback approach, arguing that it tied Social Security benefits too closely to individual accounts, that it would not be politically feasible to actually take back a large portion of the accounts at retirement that people had thought throughout their lives were their own, and that clawback plans were simply a trick to build up sufficient assets to make total privatization possible (and likely) at a later date.
6. The President’s 1999 State of the Union Social Security Proposal

Throughout 1998, as the internal technical working group considered reform options, the Administration also carried out an external strategy. Initially, this included briefings with members of Congress, active participation in public education efforts surrounding the three national Social Security forums, and preparation for the December White House Conference. For a variety of reasons, not the least of which was the potentially momentous importance of the issue, the depth of distrust of the Administration, on both sides of the aisle in Congress, was enormous. 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 White House than their Democratic colleagues and sought assurances that the White House was really serious about achieving bipartisan Social Security reform and not simply trying to trick Republicans into taking an unpopular position on the issue that Democrats could then use to take back Congress. Indeed, when House Ways and Means Chairman Bill Archer and his colleague Clay Shaw introduced a specific reform plan, some of their Republican colleagues complained that they had fallen into the Clinton Administration’s trap.

Throughout 1998 the working group continued to focus on Social Security reform plans that could be the basis of a bipartisan deal, briefing the President twice in July and twice in November on plans 1) that transferred the surplus to the trust fund (with the trust fund invested either in Treasury bonds only or partially in equities); 2) that used the surplus to fund individual accounts (add-on individual account plans); and 3) that did both simultaneously (hybrid plans and clawback plans). These briefings also included extensive discussions of ways to get a Social
Security deal done, including the “Andrews Air Force Base Approach” (the 1990 budget agreement was reached by sequestering White House officials and the Congressional leadership in non-stop negotiations at Andrews Air Force Base until a deal was reached), trying to have a bipartisan piece of legislation emerge “spontaneously” from a moderate Democrat on the Senate Finance Committee (as had almost worked on tobacco legislation), and forming a commission made up of key members of Congress and Administration officials.

Toward the end of 1998, as the possibility that the President would be impeached came clearly into view, the policy dynamic of the Social Security debate changed dramatically and it became clear to the White House that this was not the time to take risks of the scale that would be necessary to achieve a deal on an issue as contentious as Social Security reform. The President decided to follow a strategy of trying to unite the Democrats around a plan that would strengthen Social Security by transferring some of the budget surpluses to Social Security and investing a portion of the transferred funds in equities. In order to minimize the chance that the trust fund investments would provoke fears of excessive government intrusion in capital markets, the Administration decided to limit the size of the investments so that they would never exceed 5 percent of the total U.S. stock market.

The other difficult decision during this time period was whether to stick with a unified budget framework or to switch to a budget framework focused around allocating only the non-Social Security surplus. The advantage of the unified budget framework was that there would then be sufficient funds available not only to shore up Social Security but also to extend Medicare solvency, provide for
additional spending on education and military readiness, and establish new progressive
individual savings accounts outside of Social Security.\textsuperscript{32} The disadvantage was that transferring
a portion of the unified budget surplus to Social Security might be seen as “double counting.”
The advantage of the on-budget approach was that by taking Social Security out of the budget
and making transfers from the on-budget surplus to the Social Security trust fund, the double
counting critique could be avoided. The disadvantage of this second approach was that with only
the on-budget surplus to allocate, sufficient resources would not be available to extend Medicare
solvency or fund individual savings accounts, and new spending on education and military
readiness would have to be much more limited. 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.


A. The President’s 1999 State of the Union Plan

In his State of the Union address on January 19, 1999, 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. In line with then-prevailing thought and practice,
this framework proposed an allocation of \textit{unified} budget surpluses. It provided this allocation of

\textsuperscript{32} It was hoped that the accounts would seem sufficiently distinct from Social Security
that they would not be threatening to Congressional Democrats, while simultaneously showing
Congressional Republicans that the Administration might ultimately be willing to do a deal
involving more substantial individual accounts.
these surpluses over an unusually long time-frame, 15 years, in part because there were insufficient resources over the first ten years to accomplish all of the President’s objectives.

The allocation proposed in the State of the Union plan was as follows: First, 62 percent of the surpluses were allocated for Social Security, and 15 percent were allocated for Medicare. Operationally, this meant that transfers in these amounts would be made to the respective trust funds, and that the associated budgetary resources would be interpreted to have been fully “used” and not available for other purposes. Because the funds would not be needed by these programs to pay current benefits, they would be used predominantly to pay down the publicly held debt of the Federal government. A limited amount of the revenue transferred to the Social Security Trust Fund would be used to purchase corporate equities under guidelines intended to ensure independent and non-political investments. Overall, the plan was projected to extend the solvency of the Social Security trust fund to 2055.

Another 12 percent of the surpluses was allocated to create new Universal Savings Accounts (USAs). As the Administration outlined in more detail later in the spring, the accounts were proposed to involve two separate contributions from the government: an automatic contribution to all workers earning less than a specified amount, and a separate matching contribution, also available to workers with income less than a certain threshold. In order to reinforce the separateness of these accounts from Social Security, and to ensure that these accounts were not seen as undermining the existing private pension and personal saving system, the Administration proposed that contributions to 401(k) plans would qualify for government matching. Although USAs were included in the President’s budget for fiscal year 2000, they never received serious legislative consideration.
A primary motivation of these accounts was to serve as a bridge between the proponents and opponents of introducing individual accounts into the Social Security system. On the one hand, USAs allowed the Administration to join in the rhetoric of wealth creation that had been used quite effectively to promote individual accounts, and to signal the President’s willingness to discuss the proper role of individual accounts in the U.S. retirement system. On the other hand, the Administration insulated itself from attack from those who wanted to preserve the existing system, by emphasizing that the accounts as proposed would have been entirely separate from Social Security – funded from revenues outside the prevailing-law payroll tax for Social Security, and having no implication for the amount of benefits the account holder could draw from the Social Security system.

The President’s 1999 State of the Union plan also allowed for additional tax cuts for child care, long-term care, school construction, and investment in economically depressed areas, but these were to be financed internally, by curtailing some tax subsidies, closing some tax shelters and other loopholes, and otherwise improving compliance. The final 11 percent of the surpluses was allocated for military readiness and other spending. By conditioning these other uses of the surpluses on the reform of Social Security, some continuity was maintained with the earlier message of “Saving Social Security First.”

On the day after the State of the Union, Alan Greenspan testified before the House Ways and Means Committee. His prepared remarks concerned the general state of the macroeconomic situation, and so did not address the President’s proposals put forward the previous evening. However, during the question-and-answer session, Chairman Greenspan provided crucial support for the key element of the plan – the proposal to transfer 62 percent of the unified budget surplus
into the Social Security Trust Fund – but also reiterated his strong opposition to government investment in private markets. David Wessel of the *Wall Street Journal* summarized Greenspan’s message this way:

He 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.

Greenspan testified again on January 28, this time on the topic of Social Security, and reiterated the same two themes. Much of the media coverage focused on Greenspan’s opposition to government ownership of private equities. Even so, these testimonies were positive developments for the Administration within the Beltway because they lent crucial credibility to the plan’s central device for preserving a large fraction of the unified surpluses.

The plan also ran into criticism on the grounds that, in allocating unified surpluses, it “double-counted” the projected Social Security surpluses. The logic in the double counting accusation was that the Social Security surpluses are part of the unified surpluses: 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). Thus, as the critics pointed out, the Administration’s plan had the flavor of transferring to Social Security some budgetary resources that had originated from the Social Security system. The issue could be seen most clearly by considering the hypothetical case in which *all* of the unified surpluses originated from Social Security. In that case, a $1 surplus in the Social Security system would have caused the Trust Funds assets to increase by
$1.62 – $1 as under current law, and an additional 62 cents under the Administration’s plan for general revenue transfers.

The Administration responded by noting that, until that time, the budgetary debate implicitly had been seen as a debate about the unified budget, under the common – though often unspoken – assumption that the objective was to put the unified budget in balance. By contrast, the Administration was putting forward a plan that took as its objective the goal of leaving a unified surplus. If one bought into the Administration’s assertion that “business as usual” would have left no unified surpluses, then the State of the Union plan did indeed generate incremental government saving, and the Administration could be seen simply as proposing to allocate this incremental government saving to Social Security.

Republicans responded to the President’s plan by pledging to create a “lock-box” 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 10 percent across-the-board tax cut and to increases in defense spending. Democrats claimed that the Republican plans could be afforded within the on-budget surplus only by making deep cuts in non-defense discretionary spending.

B. Balancing the Budget Excluding Social Security

As noted above, one recurring theme in the debate over the State of the Union plan was the allegation that the Administration was “double-counting” the Social Security surpluses. In this context, and against a backdrop of still-dramatically-improving budget projections, the Administration significantly revamped its budget framework for the Mid-Session Review (MSR) released in June 1999. The revamped framework proposed to balance the budget in each of the
ten years in the budget window *exclusive of the operations of the Social Security system*. Indeed, the MSR projected the on-budget account would run a surplus of $5 billion in fiscal year 2000 if Social Security and Medicare reform were not enacted, and would be in balance if those reforms were enacted. In the event, the on-budget account finished fiscal year 1999 with a tiny surplus (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.

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 changing the conceptual underpinnings of the budget was not so much to take Social Security “off-budget,” because technically, it already was, but rather to refocus the political conversation on the disposition of the on-budget surpluses, and to establish the presumption that the Social Security surpluses would be used to pay down the debt held by the public – that is, they would be allowed to survive as surpluses. While the new framework obviously had a politically expedient element to it, in that it was seen as a potential block on Republican tax-cut proposals, it did have the virtue of being grounded in sound economic policy. Specifically, it accomplished a number of goals. First, it took the issue of double counting off the table, because under the new framework Social Security surpluses unambiguously were being “used” once and only once (to pay down the debt held by the public).

Second, the new approach dramatically improved 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 offsetting initiatives – 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 had increased. Thus, under the old regime, the nation probably was doing less to prepare itself for the retirement of the baby-boom generation than one would have guessed by looking at the balance in the Social Security trust fund, because the incremental contribution to government saving that resulted from the Social Security surpluses probably was considerably less than 100 percent of the Social Security trust fund accumulations.

In contrast, by refocusing the national fiscal conversation on the objective of balancing the on-budget account, the new approach (to the extent it survives) will ensure that Social Security trust fund accumulations will be backed, dollar for dollar, by government contributions to national saving. By itself, the new approach leaves open the question as to how much pre-funding of future Social Security obligations should be undertaken, but provides a much higher degree of assurance that, as a nation, we really are undertaking as much pre-funding as we say we are. In bringing trust fund accumulations and increments to government saving into alignment, the new framework took an important step toward “truth in government.”

A third substantive advantage of the new framework is that it provides a legitimate and organized context for executing general revenue transfers into the Social Security trust fund. Under the new framework, such transfers would naturally be scored as an “expense” of the on-

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33 One reasonable 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. That second leg of the overall fiscal objective would supply the answer as to how much prefunding we should be undertaking.
As a means of motivating a specific amount of general revenue transfers, the Administration proposed to tie the amount of those transfers to the interest savings that would result from using the Social Security surpluses to pay down the debt held by the public rather than for tax cuts or new spending. Thus, the new framework is the key element that needs to be in place if part of the solution to the Social Security funding shortfall is to come from additional government saving from outside the Social Security system. The Administration took advantage of this mechanism, and proposed sufficient general revenue transfers to extend the solvency of the Social Security system out to 2053. Under this framework, the debt held by the public would have been paid off, on a net basis, by 2015.

The difficulties with general revenue transfers were not fully resolved in the MSR plan, as it left Medicare as part of the on-budget account, yet proposed to transfer general revenues into the Hospital Insurance Trust Fund. Under traditional accounting and scoring rules, the transfers would, on the one hand, be treated as an outlay of the on-budget account, and also a receipt of the HI Trust Fund. Given that the latter was part of the on-budget account, the net effect on the on-budget surplus under traditional methods would have been zero, possibly encouraging the belief that those resources remained available for some other use. To deal with this, the Administration adopted the obvious modification to the usual accounting rules, and treated the general revenue transfers to Medicare as a “full use” of those monies, and therefore as reducing the amount of on-budget surpluses available for other uses. The proposed general revenue transfers into the HI trust fund were projected to extend the solvency of that program to 2027, by far the longest

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solvency horizon in the history of the program. However, no action was ever taken by the Congress to implement either the Social Security or Medicare transfers proposed by the President.

Because the details of national saving, trust fund accumulations, and fiscal objectives are not generally viewed as attractive raw materials for political messages, the new approach was proposed to be implemented through creation of a Social Security “lockbox.” In essence, the lockbox was a rhetorical device – a way of creating a mental picture of a strong safe that would contain not only the current-law Social Security surpluses, but also the general revenue transfers that the Administration included in the MSR plan. By placing these funds in the “lockbox,” the Administration meant to be increasing the public’s assurance that those monies would be saved, which in this instance operationally meant that they would be used to pay down the debt held by the public. Public message aside, the lockbox did have substance, which consisted of a set of procedural hurdles in the Congress (especially the Senate) that would have to be overcome before the government could run a deficit in the on-budget account.

That said, the most important guarantor of the robustness and integrity of the new framework probably is something a bit more amorphous – specifically, the terms on which the political debate is carried out. So long as the political debate is carried out in terms of the disposition of the on-budget surpluses, the procedural hurdles underlying the lockbox probably will not come under serious challenge. But if the consensus should ever change, no set of procedural hurdles will stand in the way of the will or the ability of the Congress to undo the rules it had put in place at some earlier time. Thus far, it appears that political consensus is holding, and that it remains politically dangerous to “dip into the Social Security surpluses.”
The framework also incorporated a comprehensive reform of Medicare, which is discussed in greater detail in the paper by Newhouse (this volume). One key element of this reform was the proposed introduction, for the first time, of competition into the Medicare marketplace, not only among private HMOs, but also between the HMOs and the traditional fee-for-service program. From the perspective of the Administration, a crucial aspect of this competition proposal was that it would have protected beneficiaries who chose to remain within the traditional fee-for-service program from paying higher premiums than under current law. A second key element was the proposed introduction of a prescription drug benefit for Medicare beneficiaries. The proposal would have established a voluntary drug benefit, but with sufficient subsidies to ensure very high participation rates.

A critical factor that smoothed the way to shifting the focus of the budgetary debate to balancing the on-budget account was the on-going improvement in the fiscal backdrop. Taken alone, the move to balancing the on-budget account would have been a significant step toward a tighter fiscal policy. In light of the stringency that had been required to achieve a balanced budget in unified terms, going the next step – by taking Social Security out of the budget – would not have been feasible had it required significant incremental budgetary pain.

Congressional Republicans generally embraced the shift in budgetary frameworks toward focusing on the on-budget account, but rejected the President’s proposed disposition of the projected on-budget surpluses. Whereas the President proposed spreading those resources across new spending (especially a Medicare drug benefit), transfers into Medicare HI, and a limited set of tax cuts, Congressional Republican leaders continued to place much greater emphasis on tax
cuts — indeed, at one point proposing that the entire projected on-budget surplus be returned to the people in the form of a tax cut.

C. Fiscal Policy in 2000

Through the beginning of 2000, the economy continued on its remarkable track. Indeed, in February, the economic expansion became the longest in U.S. history. Perhaps the most notable economic indicators were these two: Productivity growth averaged 2.8 percent between 1995 and the end of 1999, roughly twice the average that had prevailed since the devastating productivity slowdown that began in the early- to mid-1970s. And the unemployment rate fell to 4 percent, its lowest level in 30 years. It appeared that the information-technology revolution was affecting the economy very much like a favorable supply shock, with many of the opposite impacts of a sharp increase in oil prices – a pickup in productivity growth, a persistent decline in the unemployment rate, and low (even declining) inflation. Perhaps the hallmark of this period was the booming stock market, which peaked according to a number of indexes in March 2000.

In its last year, the Administration framed its fiscal policy around the goal of eliminating the debt held by the public. In a speech at the National Press Club on May 3, 2000, Secretary Summers gave five reasons why “the elimination of the net national debt held by the public should be the central objective of our nation's fiscal policy.” First, “because paying down the debt [would] 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, because it will help to increase supply in our economy, rather than demand.” The economy was, by any conventional estimate, operating beyond its normal
productive capacity. (Indeed, even the Administration’s own economic projection, published in the *Economic Report of the President*, showed a gradual upward drift in the unemployment rate over the succeeding few years.) Against that backdrop, it was especially urgent that fiscal policy mainly aim to increase aggregate supply by adding to the available pool of capital, rather than fueling aggregate demand. “Third, because a failure to pay down debt is likely to exacerbate the U.S. trade deficit.” One of the few economic imbalances one could point to, even at this advanced stage of the economic expansion, was the historically large trade deficit. In part, it was thought, the size of the trade deficit might reflect the relative economic strength of the United States compared to its major trading partners. But whatever the origins of the trade deficit, it certainly seemed an inopportune moment for a more expansionary fiscal policy that might risk appreciating the dollar, reducing foreign demand for our goods and services, and increasing our demand for theirs. “Fourth, because a failure to pay down debt will reduce our capacity to meet the demographic challenges ahead.” The looming fiscal pressures associated with the retirement of the baby boom generation demanded that the government go into that episode with as strong a balance sheet as possible. “Fifth, because 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 reminded the audience of the uncertainty surrounding the budget projections, and implicitly argued that it was far preferable to be too cautious than too aggressive in extrapolating recent economic performance into the future.

In line with these observations, the fiscal year 2000 budget framework was aimed importantly at preserving fiscal discipline. It included the following main elements. First, the Social Security surpluses were again protected in a “lockbox.” Once again, the Administration
proposed that general revenues be transferred into the Social Security Trust Fund, and that the size of these transfers be tied to the interest savings from debt reduction during 2000-2010. The transfers would begin in 2011, and would be added to the “lockbox.” Second, roughly $300 billion in general revenues would be transferred to the Medicare trust fund and used for debt reduction. Third, almost $200 billion was allocated for a prescription drug benefit for Medicare beneficiaries and health insurance coverage for low-income Americans. Fourth, more than $250 billion was allocated to a net tax cut, focusing on retirement savings, marriage penalty relief, the expansion of educational opportunities, community revitalization, affordable health care, and tax simplification.

In late June, President Clinton announced that OMB had boosted its estimate of the baseline surplus over the next ten years by $1.3 trillion. In the Mid-Session Review, the Administration proposed to take 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 basic design of the budget was to propose an allocation of the baseline surpluses over the next ten years excluding both Social Security and Medicare. The Administration maintained its proposals for Medicare reform, health coverage, and targeted tax cuts, but set aside $500 billion of the baseline surpluses as a “reserve for America’s future.”

Even if all of these funds were used for spending increases or tax reductions, the Office of Management and Budget projected that the Administration’s framework would eliminate the debt held by the public, on a net basis, by 2012. Ultimately, Congress did not adopt many of the central features of the President’s budget. Medicare was not taken off-budget, and neither Social Security nor Medicare reforms were enacted.
Working out the annual appropriations bills proved an especially arduous undertaking in 2000. A succession of continuing resolutions kept the government functioning after the beginning of the new fiscal year on October 1, and Congress did not approve the final appropriations bills until December 15.

On December 28, 2000, the President announced the Administration’s final set of budget projections. (This was to take the place of the budget that the President in a non-election year would have announced several weeks later.) These final projections of the Administration showed that the entire debt held by the public could be eliminated on a net basis by 2010, two years earlier than in the MSR.

Toward the end of the Administration, it became increasingly clear that eliminating the debt held by the public was far from outside the realm of possibility. The arithmetic associated with this possibility is quite straightforward: If the on-budget account is kept in surplus or in balance over the next ten to fifteen years, the Social Security surpluses will be enough to pay down the entire debt held by the public on a net basis. If Medicare Part A and perhaps even the Civil Service and military retirement programs are taken out of the budget to ensure that they are genuinely pre-funded to the extent their respective trust funds say they are, the debt-elimination date would come even sooner. Because the Social Security surpluses are currently projected to continue somewhat beyond the debt-elimination date, notwithstanding onset of the retirement of the baby-boom generation, the possibility arises that the Federal government might become a net creditor to the rest of the economy rather than a net debtor. In other words, the Federal
government might end up being a net holder of private assets.\textsuperscript{35} The Clinton Administration recognized this possibility, but never wrestled with the associated policy issues at any great length.

For several reasons, the relevance of considerations related to asset accumulation is greater than seems apparent on first inspection. First, a certain amount of the debt held by the public is in forms that would be difficult or unpopular to retire. For example, roughly $200 billion is held in the form of Savings Bonds, and it is difficult to imagine that this program – which provides a convenient savings vehicle especially for low- and moderate-income households – would be terminated in the name of increasing national saving. Second, some of the debt is long-term, and is scheduled to mature well after the debt would be eliminated on a net basis under current projections. Some portion could be bought back at market prices before its scheduled maturity date, but at some unknown point, the market might begin to demand an increasing premium in order to be persuaded to give up more of the debt.\textsuperscript{36} In sum, the debt

\textsuperscript{35}In some very limited respects, the Federal government already holds private assets. To pick a few examples, 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 plans that have been turned over to it. For a variety of reasons, none of these examples is seen as particularly telling for the issue of whether large-scale investments could be conducted on behalf of the Social Security trust fund or the central government. The most important of these reasons is that the size of investment that might be involved in the case of Social Security would dwarf the scale of these pre-existing holdings.

\textsuperscript{36}Of course, the extent to which the debt held by the public can be reduced from its current level over any given horizon depends on the Treasury Department’s issuance policy from here forward. Already, there has been considerable speculation in the financial press that Treasury’s 30-year bonds (both conventional and inflation-indexed) might be discontinued in light of the fact that new bonds of that maturity would extend so far beyond the current debt-elimination date.
elimination date under current projections is only about a decade away, even if only the Social Security surpluses are used to pay down debt, and other considerations seem mostly to militate toward bringing forward the date at which asset balances begin to accumulate rather than pushing it back.

As the issue of debt elimination came more clearly into view, a number of commentators 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. That is, 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. Financial markets clearly value these and other functions performed by Treasury securities, but it is not immediately evident whether they are associated more closely with Treasury securities *per se* or simply with the existence of some market for debt that is very deep and very liquid.

In the last year or two, as markets have come to recognize more clearly the possibility of at least a substantial paydown of Treasury debt (even if not total elimination), there has been substantial innovation, as potential alternative instruments that could take the place of Treasury securities vie for lead status. Where this process will ultimately lead is, at this stage, unclear, especially given that this may be a case in which the logic of the market may dictate that there is room for only one successor rather than many. (If there were more than one potential successor, the market might eventually “tip” to one or the other in order to gain the extra efficiency associated with maximum depth and liquidity in one single market.)
That said, the current situation raises the question as to whether the existence of a deep and liquid market for Treasury securities provides at least some benefit for the economy that either (a) cannot be provided by any private issuer, or (b) that the Federal government can provide more efficiently, or (c) could potentially be provided through some non-federal vehicle, but that might as well be provided by the Federal vehicle so that Federal taxpayers can reap the financial rewards associated with what might be, in effect, a valuable financial franchise. It is extremely difficult to know how one might go about attempting to quantify the benefit provided by a deep and liquid Treasury market. But that benefit would have to be weighed against the cost of either (a) saving less through government means, and therefore potentially saving less overall at the national level; or (b) allowing a greater accumulation of private assets by the Treasury than otherwise in order to maintain a greater level of debt issuance.

Accumulation of private financial assets by the Federal government raises all the same issues regarding corporate governance and potential political interference in capital markets as arise in the context of considering whether to invest part of the Social Security trust fund in private assets. Indeed, some have argued that the dangers are even greater given that the assets would be held by the central government itself rather than by the Social Security trust fund, which is seen as at least somewhat removed from the political process and as intimately linked with a popular cause and powerful lobby. In general, the same potential solutions to the problem pertain: The federal government could choose to confront the problem head-on, and 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, at least part of the problem could be shifted to the Social Security Trust Fund (though as we discussed earlier, this
would hardly be seen as solving the problem); if the Trust Fund were to invest part of its holdings in private securities, more government debt would be available for ownership by the public, and hence for retirement by the central government. Still another possibility is that individual accounts might be a method for preserving some of the government saving inherent in the projected surpluses, while reducing (though probably not avoiding altogether) the governance and political interference concerns associated with centralized investment. Finally, increases in spending or larger tax cuts obviously would be further alternative methods of dealing with unwanted asset accumulation, though at the sacrifice of some or all of the potential government contribution to national saving.

Dealing with the asset accumulation problem by increasing government spending or reducing taxes could have severe implications for the validity of the Social Security trust fund as a signal of the preparation that the nation is undertaking for the retirement of the baby-boom generation. As we have emphasized earlier, a key advantage of focusing on balancing the budget excluding Social Security is that government saving will tend, at least on average over time, to be approximately equal to the accumulation in the Social Security trust fund. If the nation reverts to focusing on balancing the unified budget, that important link will be lost, and there would in that case be no necessary connection between government saving and the accumulation in the trust fund.
8. 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.37 Perhaps a potent symbol of the degree to which perceptions of the fiscal situation had improved over the decade was the announcement on May 13 that the “debt clock” in New York’s Times Square would be dismantled in September 2000, essentially for lack of interest.38 The tax increases and spending restraint imposed by the 1990, 1993, and 1997 budget deals played a significant part in this improvement in the budget picture. But good luck in the form of a strong economy combined with the absence of policy actions to dissipate the incipient surpluses were probably at least as important. And the impact of the initial policy decisions on the subsequent economic performance should not be discounted.

While the Clinton Administration’s fiscal policy was tremendously successful in bringing the budget deficit under control and reducing the level of debt to GDP from 50 percent down to 35 percent, the Administration was considerably less successful in its attempts 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 it holds, ensure that the debt to GDP ratio continues to fall steadily for the next decade. But the Administration’s attempts to lock-up 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

37 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.”

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, it is hard not to be disappointed that the opportunity to prefund future retirement and health benefits was not seized.
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Notes. Revisions are from January to January of the years shown. Decomposition is by the CBO, cumulated by the authors across projection updates.
Figure 1: Federal Budget Surplus and Debt Held by the Public: 1946 - 2000
(percent of GDP)

Figure 2: CBO Budget Surplus Projections
(billions of dollars)
Figure 3: Revisions to CBO Surplus Projections Between 1993 and 2001
(billions of dollars)

*Includes small revisions where source was not reported by the CBO.

Figure 4: Net National Saving and its Components
(percent of GDP)