

GAO

Testimony

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LONG-TERM BUDGET
ISSUES

Moving From Balancing
the Budget to Balancing
Fiscal Risk

Statement of David M. Walker
Comptroller General of the United States



Chairman Domenici, Ranking Member Conrad, and other Senators, I am pleased to be here today to present GAO's perspective on the long-range fiscal policy challenges facing this Congress and our nation. In recent testimony before this committee, Federal Reserve Chairman Alan Greenspan observed that the new, larger surplus projections have reshaped the choices and opportunities before us.¹ That is true. As I have noted before, this Administration and this Congress enter the 21st Century facing new opportunities—and new challenges. You have the opportunity to respond to many of today's wants, but also the obligation to prepare for the long term.

As you face budget choices in a time of projected surpluses, I'd like to hit a few points:

- First, as the Congressional Budget Office (CBO) notes these projections are based on a set of assumptions that may or may not hold—no one should design tax or spending policy pegged to the precise numbers in any 10-year forecast.
- Higher 10-year surplus projections provide room to address pent-up demands for some tax cuts and/or additional spending kept in abeyance during years of fighting deficits. It is important to remember, however, that while projections for the next 10-year period look better, the long-term outlook looks worse. Without a change in entitlement programs, demographics will overwhelm the surplus and drive us back into escalating deficits and debt.
- The rapid increase in surplus projections brings closer the time at which the surplus is expected to generate cash above that needed to redeem debt held by the public. Congress and the President face new challenges in saving for the future as we approach a time when there will be almost no publicly held debt.
- Budget choices should be viewed in terms of a balanced portfolio of options. In the aggregate, choices should be balanced across different levels of fiscal risk to the long-term outlook by using a portfolio approach. Attention must be paid not only to responding to current needs but also to making choices that increase the capacity of future generations to make their own choices by promoting long-term growth and reducing the relative future burden of entitlement programs.

¹Alan Greenspan, Testimony before the Committee on the Budget, U.S. Senate (January 25, 2001).

Before looking ahead, I think it is useful to take a moment to remind ourselves of how we got where we are today. We face burgeoning surplus projections not only because of sustained strong economic growth but also as a result of many difficult decisions made by earlier Congresses. These decisions, taken at different times and maintained over time, ultimately helped us to slay the deficit dragon. They included a budget control regime that imposed caps on discretionary spending and a pay-as-you-go (PAYGO) process on mandatories and revenues. They included the difficult spending and tax decisions that implemented this process. Fiscal discipline was enforced. As these processes and measures took hold, little by little deficits receded. As the unified budget went into surplus, a bipartisan consensus emerged on saving the Social Security surpluses, and this consensus has also played an important part in today's favorable fiscal outlook and reduced levels of debt held by the public.

Both the Office of Management and Budget (OMB) and CBO now show not only Social Security surpluses but also increasing levels of non-Social Security, or on-budget, surpluses over the next 10-year period. It is these projected surpluses that have changed the budget landscape dramatically from even a year ago. The surpluses offer a welcome opportunity to address the legitimate pent-up demands held in abeyance during the era of deficits. At the same time the surplus estimates imply that, absent policy or economic change, debt held by the public could be virtually eliminated before the end of this decade. As Chairman Greenspan recently emphasized in testimony before this Committee, the possible elimination of debt held by the public is an unexpected aspect of the new budgetary environment. In modern times, it is unprecedented. As you know, Mr. Chairman and Senator Conrad, GAO has done and is doing some work on debt management, and later in this testimony I will discuss some of the emerging issues in this area we have identified in our ongoing work.

The question before this Congress is how to balance today's wants and needs against our long-term challenges. The advent of actual and projected surpluses provides a window to respond to a wide range of demands held in abeyance during years of restraint. The surplus does not, however, eliminate our obligation to be prudent in dealing with the taxpayers' funds. As we noted recently in the Performance and Accountability Series² the newfound budget surpluses provide an opportunity—to move from a focus on annual budget deficits to a reexamination of what government does and how the government does business.

²*Major Management Challenges and Program Risks: A Governmentwide Perspective* (GAO-01-241, January 2001).

Further, while we can rejoice in the prospect of burgeoning surpluses, at the same time we need to proceed with a measure of caution. It is important also to remember that only a few years ago OMB and CBO projected deficits as far as the eye could see. I do not say this to question the new projections but simply to remind us of their limitations and how they are meant to be used. These new projections, like the ones before them, are a “what-if”—not a precise prediction of the future. The projections are useful because they quantify the likely future budgetary consequences if we continue current federal policies without change. As such, they serve as a reference point and are a key tool for policymakers in choosing between alternative policy courses. At the same time they are built on a complex set of assumptions, and I want to talk a little about those later because we need to understand these assumptions if we are appropriately to understand the baseline projections.

Clearly, these new surplus projections present us with different—but not necessarily easier—issues and trade-offs than was the case in the era of large and persistent deficits. Indeed, in my view these surpluses present both opportunity and obligation as well. While much of the discussion will properly concern the opportunities the surpluses afford, I believe it is important to remember that they bring with them a stewardship obligation. By stewardship obligation, I mean that today’s budget decisions need to be made with the future in mind. We must not only respond to the legitimate needs of today but also take into account the longer term fiscal pressures that loom ever larger in coming decades as the nation ages and the baby-boom generation retires. Our long-term simulations, updated using CBO’s new budgetary estimates, show that spending for federal health and retirement programs eventually overwhelms even today’s projected surpluses. This is true even assuming no additional spending for defense, education, or a Medicare prescription drug benefit—i.e., even if the entire unified surplus were saved. The aging of our nation, which will truly begin to affect the budget just after the 10-year budget window ends, is one key backdrop for the choices this Congress will make.

These long-term pressures which cast a shadow on today’s budgetary deliberations are a kind of fiscal risk. Budget policy actions may be seen in terms of their impact on the long term. Our work on budget choices in states and other nations suggests an array of fiscal actions that may serve as a framework for thinking about budget choices in a surplus environment. No one factor is likely to dominate and the allocation of these surpluses among debt reduction, new or increased spending, and tax cuts is inherently a matter for political choice. However, these choices can be made in the context not only of today’s needs but also of the future realities. Policymakers might think in terms of a portfolio of actions in

which a balanced approach may spread and moderate any related fiscal risk.

Current-Law Budget Projections May Understate Future Spending and Overstate Future Revenues

In using baseline budget projections, we need to understand what assumptions they incorporate and how realistic these assumptions may be. Intended as a neutral reference point for comparing alternative policies, baseline projections make no assumptions about future policy change. The overarching assumption is that current laws concerning tax policy and spending continue unchanged. The conventions governing baseline projections are appropriate and understandable in the context of budget enforcement purposes. However, in using these projections as a basis for policymaking, it is important to remember what they are and what they are not. The baseline is just that—a baseline from which to estimate the impact of policy actions; one would expect the ultimate outcomes to be different—particularly over a decade.

Some analysts have suggested that baseline projections may understate likely future discretionary spending while overstating likely future revenues. Where current law does not provide a determinative rule—as is the case for discretionary spending after expiration of the caps—both CBO and OMB must make some assumptions. CBO’s most commonly used projection for discretionary spending—and the one we use for the first 10 years of our long-term simulations—is the baseline under which discretionary spending grows with inflation. A number of observers of the federal budget, including former CBO directors Robert Reischauer and Rudolph Penner, have suggested that this inflated discretionary assumption is unrealistic. One analysis has pointed out that a growth rate no higher than inflation would mean that future per-capita discretionary spending would decline in real terms during an era of budget surpluses.³ In addition, projections based on current-law assumptions may overstate likely future revenues. For example, the baseline projections assume expiration of a set of about 20 tax credits—including the research and experimentation tax credit—which have been routinely extended in the past. The baseline projections also assume no change to the alternative minimum tax, which is expected to affect an increasing number of middle-class taxpayers.

³Robert Greenstein, “Can the New Surplus Projections Accommodate a Large Tax Cut?” Center on Budget and Policy Priorities (January 2001). See also the Concord Coalition’s “The Surplus Field of Dreams” (October 11, 2000), and Alan Auerbach and William G. Gale, “Perspectives on the Budget Surplus,” NBER Working Paper 7837 (August 2000).

All projections are surrounded by uncertainty. In using budget estimates, we need to keep in mind that budget estimates are not—and are not meant to be—a crystal ball. CBO itself has warned against attributing precision to its projections, stating that actual budgetary outcomes will almost certainly differ from the baseline projections—even absent any policy changes.⁴ CBO notes that its estimate of the 2006 surplus could vary by as much as \$400 billion in either direction. As CBO has said, the value of the 10-year estimates is that they allow Congress to consider the longer-term implications of legislation rather than focus only on the short-term effects.⁵ No policy should assume the exactness of baseline projections; relatively small shifts can lead to large year-to-year differences.

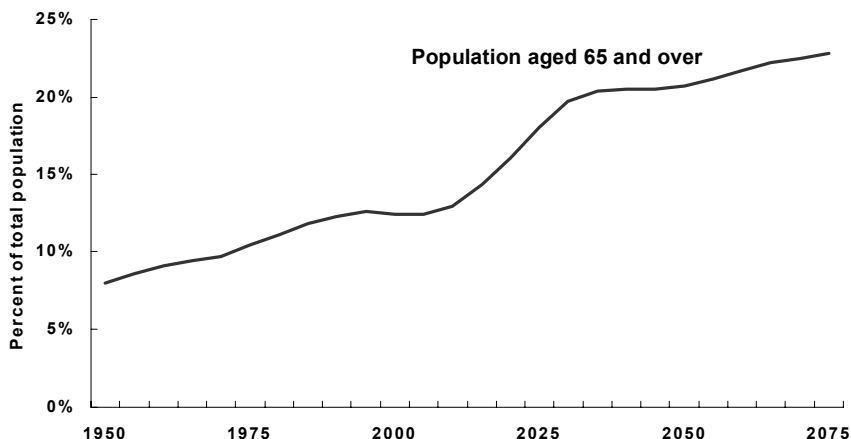
Despite Today's Outlook for Large and Growing Surpluses, in the Long Term Deficits Will Re-emerge

While considerable uncertainty surrounds both short- and long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. In addition demographic trends are more certain than budget projections! Although the 10-year horizon looks better in CBO's January 31 projections than it did in July 2000, the long-term fiscal outlook looks worse. In the longer term—beyond the 10-year budget window of CBO's projections—the share of the population over 65 will begin to climb, and the federal budget will increasingly be driven by demographic trends.

⁴CBO, *The Budget and Economic Outlook: Fiscal Years 2002-2011* (January 2001).

⁵CBO, *The Budget and Economic Outlook: An Update* (July 2000), p. 22.

Figure 1: Aged Population as a Share of Total U.S. Population Continues to Grow

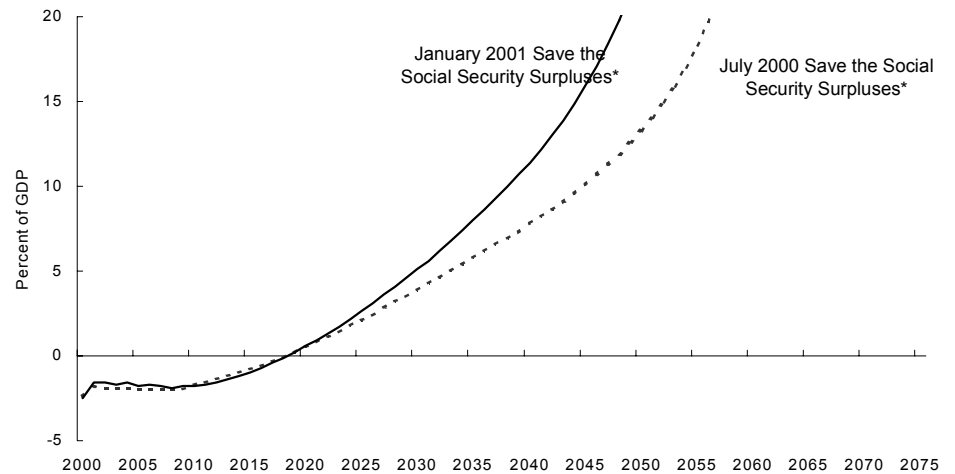


Note: Projections based on the Trustees' intermediate assumptions.

Source: *The 2000 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

As more and more of the baby boom generation enters retirement, spending for Social Security, Medicare, and Medicaid will demand correspondingly larger shares of federal revenues. Federal health and retirement spending will also surge due to improvements in longevity. People are likely to live longer than they did in the past, and spend more time in retirement. Finally, advances in medical technology are likely to keep pushing up the cost of providing health care. In contrast to the improvement in the 10-year projections, our updated simulations—shown in figure 2—show a worsening in the long-term fiscal outlook since July. This worsening is largely due to a change in the assumptions about health care costs over the longer term.

Figure 2: Comparison of Unified Deficits as a Share of GDP Under the Save the Social Security Surpluses Simulation, July 2000 Update and January 2001 Update



*Data end when deficits reach 20 percent of GDP.

Source: GAO's January 2001 analysis.

In recent months there has been an emerging consensus that the long-term cost growth assumption traditionally used in projecting Medicare and Medicaid costs in the out-years is too low. A technical panel advising the Medicare Trustees stated this conclusion in its final report. Charged with reviewing the methods and assumptions used in the Trustees' Medicare projections, the panel found that the methods and assumptions were generally reasonable with the exception of the long-term cost growth assumption. Basing its finding on recent research and program experience, the panel recommended that in the last 50 years of the 75-year projection period, per-beneficiary program costs should be assumed to grow at a rate one percentage point above per-capita gross domestic product (GDP) growth.⁶ CBO made a similar change to its Medicare and Medicaid long-term cost growth assumptions its October 2000 report on the long term.⁷ Given this convergence of views, we have incorporated higher long-term

⁶Technical Review Panel on the Medicare Trustees Reports, *Review of Assumptions and Methods of the Medicare Trustees' Financial Projections* (December 2000), p. 27. The panel stated that it believes that the long-term forecasts should reflect the impact of changes in per-beneficiary spending in addition to the impact of demographic change (p. 28). A more detailed rationale for the recommendation can be found in chapter III of the final report (pp. 27-42).

⁷CBO, *The Long-Term Budget Outlook* (October 2000), pp. 3 and 19. See also the Medicare technical panel's discussion of CBO's similar assumption (p. 38).

health care cost growth consistent with the Medicare technical panel's recommendation into our January update.⁸

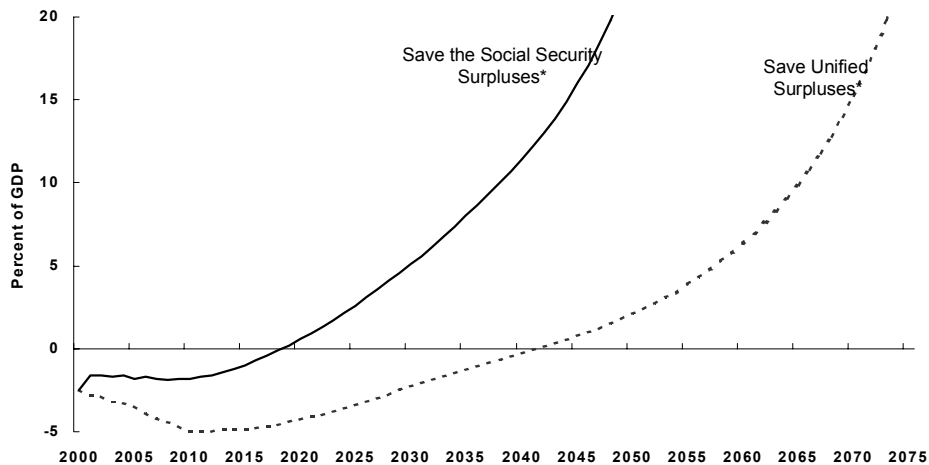
The message from our long-term simulations, which incorporate CBO's 10-year estimates,⁹ remains the same as it was a year ago. Indeed, it is the same as when we first published long-term simulations in 1992.¹⁰ Even if all projected unified surpluses are saved and used for debt reduction, deficits reappear in 2042. If only the Social Security surpluses are saved, unified deficits emerge in 2019. (See figure 3.) In both scenarios deficits would eventually grow to unsustainable levels absent policy changes.

⁸It is not known at this time whether the panel's recommendation on Medicare's long-term cost growth will be adopted by the Trustees and incorporated into the 2001 Hospital Insurance and Supplementary Medical Insurance estimates.

⁹These simulations are based on the projections CBO released last week. As is our standard practice, we use CBO's estimates for the 10-year budget window. Beyond the 10-year window, we assume that all current-law benefits in entitlement programs are paid in full (i.e., we assume that all promised Social Security benefits are paid including after projected exhaustion of the OASDI Trust Funds in 2037) and that discretionary spending grows at the same rate as the economy.

¹⁰*Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy* (GAO/OCG-92-2, June 5, 1992), *The Deficit and the Economy: An Update of Long-Term Simulations* (GAO/AIMD/OCE-95-119, April 26, 1995), *Budget Issues: Deficit Reduction and the Long Term* (GAO/T-AIMD/96-66, March 13, 1996), *Budget Issues: Analysis of Long-Term Fiscal Outlook* (GAO/AIMD/OCE-98-19, October 22, 1997), *Budget Issues: Long-Term Fiscal Outlook* (GAO/T-AIMD/OCE-98-83, February 25, 1998), and *Budget Issues: July 2000 Update of GAO's Long-Term Simulations* (GAO/AIMD-00-272R, July 26, 2000).

Figure 3: Unified Deficits as a Share of GDP Under Alternative Fiscal Policy Simulations

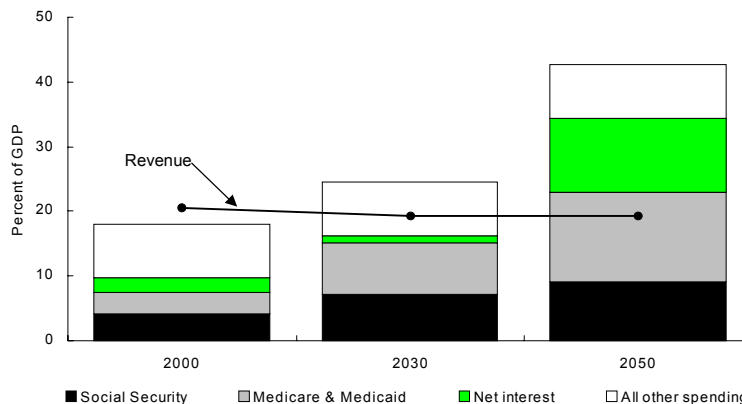


*Data end when deficits reach 20 percent of GDP.

Source: GAO's January 2001 analysis.

To move into the future with no changes in federal health and retirement programs is to envision a very different role for the federal government. Assuming, for example, that Congress and the President adhere to the often-stated goal of saving the Social Security surpluses our long-term model shows a world by 2030 in which Social Security, Medicare, and Medicaid increasingly absorb available revenues within the federal budget. Under this scenario, these programs would require more than three-quarters of total federal revenue. (See figure 4.)

Figure 4: Composition of Federal Spending as a Share of GDP Under the Save the Social Security Surpluses Simulation



Notes: (1) Revenue as a share of GDP declines from its 2000 level of 20.6 percent due to unspecified permanent policy actions that reduce revenue and increase spending to eliminate the non-Social Security surpluses. (2) The “Save the Social Security Surpluses” simulation can only be run through 2055 due to the elimination of the capital stock.

Source: GAO’s January 2001 analysis.

Little room would be left for other federal spending priorities such as national defense, education, and law enforcement. Absent changes in the structure of Social Security and Medicare, some time during the 2040s government would do nothing but mail checks to the elderly and their healthcare providers. Accordingly, substantive reform of Social Security and health programs remains critical to recapturing our future fiscal flexibility.

Since these simulations assume current-law entitlement benefits, they both overstate and understate the challenge. They overstate it because they assume Congress and the President would take no action to change the cost structure of these programs. However, they understate it because they also assume no benefit enhancements such as the addition of coverage for prescription drugs. In addition, these simulations—like the budget—do not recognize the long-term cost implications of insurance programs, environmental cleanup liabilities and other long-term commitments. In other words, in some ways this could be seen as an optimistic scenario!

The government undertakes other activities and programs that directly obligate it to spend in the future. While some steps have been taken to

improve financial statement reporting of a number of these commitments, more needs to be done. In addition, many future costs are not reflected in either budget projections or long-term simulations. Explicit liabilities not reflected in the budget can be sizable. For example, estimates indicate that environmental cleanup of government-caused waste is expected to cost the federal government at least \$300 billion. Other future financial commitments and contingencies are also important considerations.

The future costs of other activities are often difficult to estimate, but nonetheless can add to future fiscal stress. Some, such as credit subsidy costs, are in the budget and thus in the baseline; others, like the risk assumed by federal insurance programs, are not. All of these as well as demands for increased federal support in areas ranging from health insurance to national defense will compete for a share of the fiscal pie in the future—a pie that will already be increasingly encumbered by higher costs for the elderly. This highlights the government’s stewardship responsibility to provide future generations with sufficient budgetary flexibility to make their own choices and an economic base sufficient to finance current commitments as well as future needs.

Budget Policy in a Time of Surplus

Today Congress and the President face a very different set of budget choices than did your recent predecessors. For over 15 years fiscal policy has been seen in the context of the need to reduce the deficit. The policies and procedures put in place to achieve a balanced budget do not provide guidance for fiscal policy in a time of surplus. At the same time, as Chairman Greenspan warned last month, we “need to resist those policies that could readily resurrect the deficits of the past and the fiscal imbalances that followed in their wake.”

As you know, we have looked at a number of other countries that have already faced this challenge.¹¹ Like the United States, these nations achieved budget surpluses largely as the result of improving economies and sustained deficit reduction efforts. After years of restraint, there are pent-up demands—for tax cuts and/or for spending. In several notable cases, these countries met current demands while retaining surpluses for longer-term economic goals. How do countries meet these demands without abandoning restraint? The countries we reviewed articulated a compelling case for sustaining surpluses and developed a fiscal policy

¹¹*Budget Surpluses: Experiences of Other Nations and Implications for the United States* (GAO/ AIMD-00-23, November 2, 1999). In the report we looked at Australia, Canada, New Zealand, Norway, Sweden, and the United Kingdom.

framework that addressed current needs within the context of broader economic targets or goals. Some adopted fiscal targets such as debt-to-GDP ratios as a guide for decision-making while others such as Australia attempted to focus on the impact of fiscal policy on national saving and economic growth.

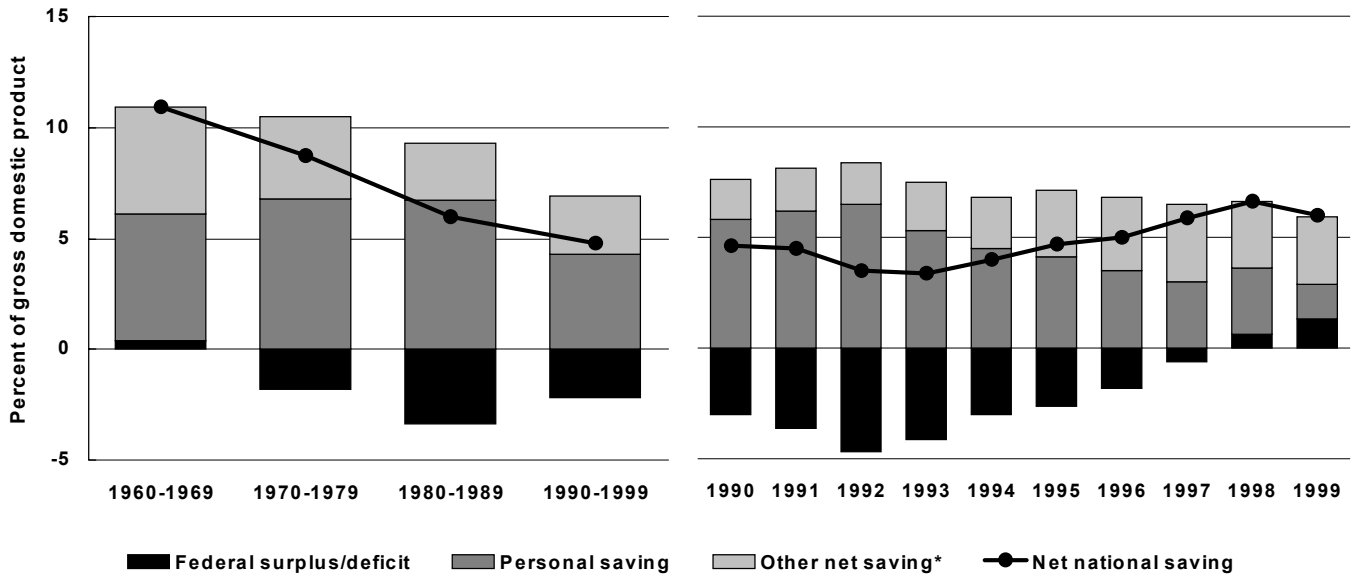
Achieving consensus on a long-term fiscal policy goal this year may seem unlikely. Nevertheless, I believe it is important that Congress and the President look at budget choices today in the context not only of today's needs and demands but also of the long-term pressures we know loom on the horizon. Today's surpluses create, in effect, a unique window of opportunity to better position the government and the nation to address both current needs as well as the longer-term budget and economy we will hand to succeeding generations. Our long-term model illustrates how important it is for us to use our newfound fiscal good fortune to promote a more sustainable longer-term budget and economic outlook so that future generations can more readily afford the commitments of an aging society.

Deficits, Debt, and National Saving

Today's budget decisions have important consequences for the living standards of future generations. The financial burdens facing the smaller cohort of future workers in an aging society would most certainly be ameliorated if the economic pie were enlarged. This is no easy challenge, but in a very real sense, our fiscal decisions affect the longer-term economy through their effects on national saving. Recent research estimated that increasing saving as a share of GDP by one percentage point each year would boost GDP enough to cover 95 percent of the increase in elderly costs between now and 2050.

Simply put, we are not saving enough as a nation. Personal saving is at a 40-year low. As shown in figure 5, the reduction of federal deficits and the emergence of budget surpluses in recent years have slowed the long-term decline in national saving. While investment needed to promote growth has been supported by foreign capital in recent years, the profits due to foreign investment go abroad. What would happen if in the future foreign investors found more attractive opportunities elsewhere? The most viable strategy for expanded growth in the long run is to increase saving from our own economy. Since expanding the nation's productive capacity through saving and investment is a long-term process, increasing saving now is vital since labor force growth is expected to slow significantly over the next 20 years.

Figure 5: Composition of Net National Saving (1960-1999)



*"Other net saving" consists of net saving by businesses and state and local governments.

Source: Department of Commerce, Bureau of Economic Analysis.

Traditionally, the most direct way for the federal government to increase saving has been to reduce the deficit or—more recently—to run a surplus. Although the government may try to increase personal saving, results of these efforts have been mixed. As a general rule the surest way for the federal government to affect national saving has been through its fiscal policy.

In general, saving involves trading off consumption today for greater consumption tomorrow. When the government saves by reducing debt by the public, it helps lift future fiscal burdens by freeing up budgetary resources encumbered for interest payments—which currently represent more than 12 cents of every federal dollar spent—and by enhancing the pool of economic resources available for private investment and long-term economic growth. This is especially important since—as I noted a year and a half ago—we enter this period of surplus with a large overhang of debt held by the public. Indeed, we should be a little more subdued in congratulating ourselves on the decline in debt held by the public—we are still significantly above the debt/GDP ratio of the late 1970s. Given the

demographic pressures looming, today's level of publicly held debt is not a good benchmark.

However, current projections show that—depending on the budget policies adopted—the United States could reach a point in this decade at which annual budget surpluses could not be fully used to reduce debt. Although estimates of exactly when this might occur vary, most put it between 2004 and 2011. If the entire unified surplus is saved, this point is likely to be reached in sometime in the next 5 years; if only the Social Security surplus is saved, this point will be delayed until the second half of the decade.

This would raise a number of issues: whether and if so how the government should hold nonfederal assets; whether and if so how a market for debt held by the public should be maintained; how do we as a nation raise the level of national saving if reducing federal debt held by the public is not an option.

The issues Chairman Greenspan raised concerning government ownership of nonfederal assets deserve careful consideration. I note that while Chairman Greenspan opposed such a step, he also said that if the government were to acquire nonfederal assets, he would prefer that they be allocated to the Social Security Trust Funds. At GAO we have looked both at the experiences of other countries during times of declining debt and at the question of trust fund investments in equities. We believe this work can assist you in your deliberations.

For example, in our ongoing work looking at other nations' experiences with declining debt, we found that some have decided to hold some nonfederal assets as part of their efforts to deal with long-term pressures. With the advent of surpluses, Norway established a goal of sustained surpluses in order to build up savings to address long-term fiscal and economic concerns resulting primarily from an aging population and declining petroleum reserves. As a vehicle for accumulating assets, the government created the Government Petroleum Fund in 1991 to help manage Norway's petroleum wealth over the long term. The Fund serves several important fiscal and economic functions. By investing surpluses, the Fund is an instrument for saving part of Norway's petroleum revenues for the next generation. During the 1990s, Canada modified its pension system to invest in nonfederal assets as one way to improve the system's sustainability. Sweden also invests a portion of its pension funds in nonfederal assets. Management of Norway's Petroleum Fund is the responsibility of the Ministry of Finance, which has delegated the task of operational management of the Fund to Norway's central bank. Both

Canada and Sweden have established separate boards to oversee the investment of their fund assets. In the near future, we plan to conduct a study of other nations that invest in nonfederal assets in order to learn more about how they deal with governance issues.

In 1998, we reported on the implications of allowing the Social Security Trust Funds to invest in nonfederal assets, specifically equities.¹² One of the implementation issues we looked at was that of governance—at the concern that there would be tremendous political pressures to steer the trust funds’ investments to achieve economic, social, or political purposes. We concluded that passively investing in a broad-based index would reduce, but not eliminate, the possibility of political influence over the government’s stock selections. The question of how to handle stock voting rights, however, seemed likely to be more difficult to resolve. To blunt concerns about potential federal meddling, the government’s stock voting rights could be restricted by statute or delegated to investment managers.

The issue of how to select stock investments also emerged when the federal employees’ Thrift Savings Plan (TSP) was created. To eliminate political influence in TSP’s stock investment decisions, the Congress restricted TSP investments to widely recognized broad-based market indexes; thus the portfolio composition is automatically determined by the market index chosen and consideration of nonfinancial objectives is precluded. TSP board members and employees are subject to strict fiduciary rules, and breaching their fiduciary duty would expose them to civil and criminal liabilities. The fiduciary rules require board members and employees to invest the money and manage the funds solely for the benefit of the owners of the individual accounts—the participating federal employees and their beneficiaries. TSP board members and employees are prohibited from exercising stock voting rights, and voting instead is delegated to investment managers according to their own guidelines. Obviously, the design and management of any federally owned assets will be critical to mitigate the risks of political interference. Since TSP assets are owned by federal employees, it cannot be seen as directly analogous to government investment. Nevertheless, it can be helpful in considering these issues.

Government ownership of nonfederal assets is obviously complicated and would carry certain risks. Although the governance issues may not be insurmountable, another possible concern is the magnitude of federal

¹²*Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy* (GAO/AIMD/HEHS-98-74, April 22, 1998).

involvement in the financial markets. Although the federal government would become the largest single investor, the amounts invested might not seem disproportionately large in terms of the size of the U.S. financial markets. Under our Save the Social Security Surpluses simulation, the federal government would buy nonfederal assets for about a decade and cumulative federal holdings would peak at about 2 percent of GDP assuming that a federal debt market is not maintained. This would represent about 1 percent of the stock market or 4 percent of the corporate bond market today. Any price effects associated with the federal government acquiring and then selling these assets are uncertain. However, the government would not necessarily be selling its nonfederal assets in this window.

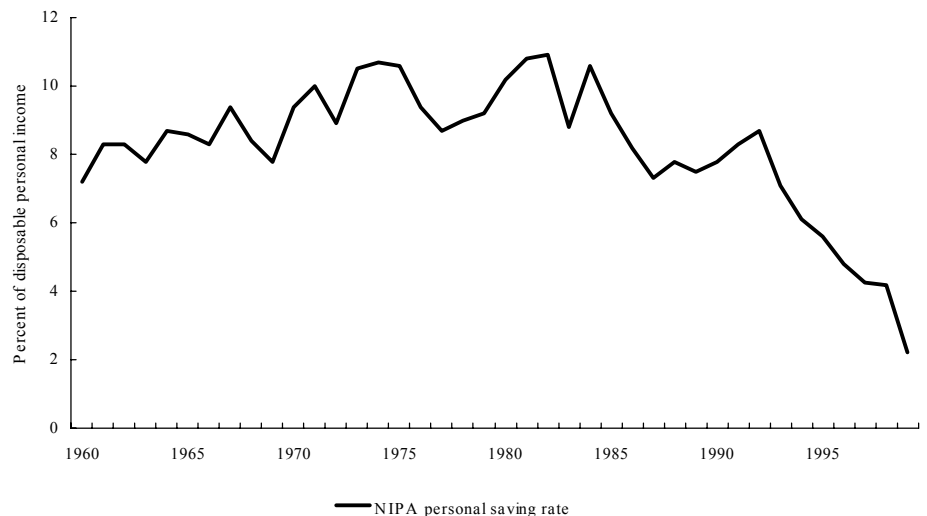
If nonfederal assets are to be held by the government, the question arises whether they could be used to prefund a portion of federal commitments and liabilities. Since a successful stock investment strategy should be grounded in a long-term outlook, the idea of investing in nonfederal assets could be considered appropriate for federal programs with a long time horizon. For example, federal civilian and military retirement programs could buy and hold assets that match the expected timing of their liabilities.

As I have already noted, there is a growing body of experience in other nations that might help us understand this new landscape better. It is worth noting that investing in the financial markets is a standard practice for state and local governments, and the experiences of public pension funds may yield some insights into the implications of the federal government investing on behalf of Social Security or other federal retirement programs. Other nations have decided that the potential risks of political interference with markets can be managed and are outweighed by what they perceive as a risk of failing to save for the future or providing a cushion for contingencies. These trade-offs are inherently political decisions—and although we can look to others for insights, we will have to resolve these issues in our own way.

If the governance, control and size issues loom so large that there is a consensus the federal government should not hold nonfederal assets, we face a new set of issues: should we avoid eliminating debt held by the public, and if so, how? How then would we accumulate sufficient national saving to promote the level of economic growth needed to finance the baby boom retirement? The surest way for the federal government to raise national saving has been by raising government saving. How to raise national saving in an environment of zero federal debt is a complex question. The government could aim for a balanced budget once the

federal debt held by the public is eliminated. In such a case, all national saving would have to be achieved through increased private saving. Whether existing federal incentives for people to save have been effective in increasing private saving and ultimately national saving is open to question. Even with preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined, as shown in figure 6.

Figure 6: Personal Saving Rate (1960-1999)



Note: This rate as measured in the National Income and Product Accounts (NIPA) is personal saving as a percentage of disposable personal income.

Source: Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, Tables 5.1 and 2.1.

Some have suggested that one option would be using the surpluses to finance individual saving accounts. Various proposals have been advanced that would create a new system of individual accounts as part of comprehensive Social Security reform, while other proposals would create new accounts outside of Social Security. Individual account proposals also differ as to whether individuals' participation would be mandatory or voluntary. If the goal of individual account proposals is to increase national saving, careful consideration must be given to the specifics of design.¹³ Matching provisions may affect how much such accounts

¹³*Social Security: Capital Markets and Educational Issues Associated With Individual Accounts* (GAO/GGD-99-115, June 28, 1999).

increase national saving. On another dimension, allowing early access to these accounts increases people's willingness to put money in them-but reduces their usefulness as retirement accounts. One possible approach might be to use part of any realized surplus as a kind of surplus dividend that could be returned in the form of an individual saving account. Again, design features including targeting and limitations on access would be important.

Entitlement Reform

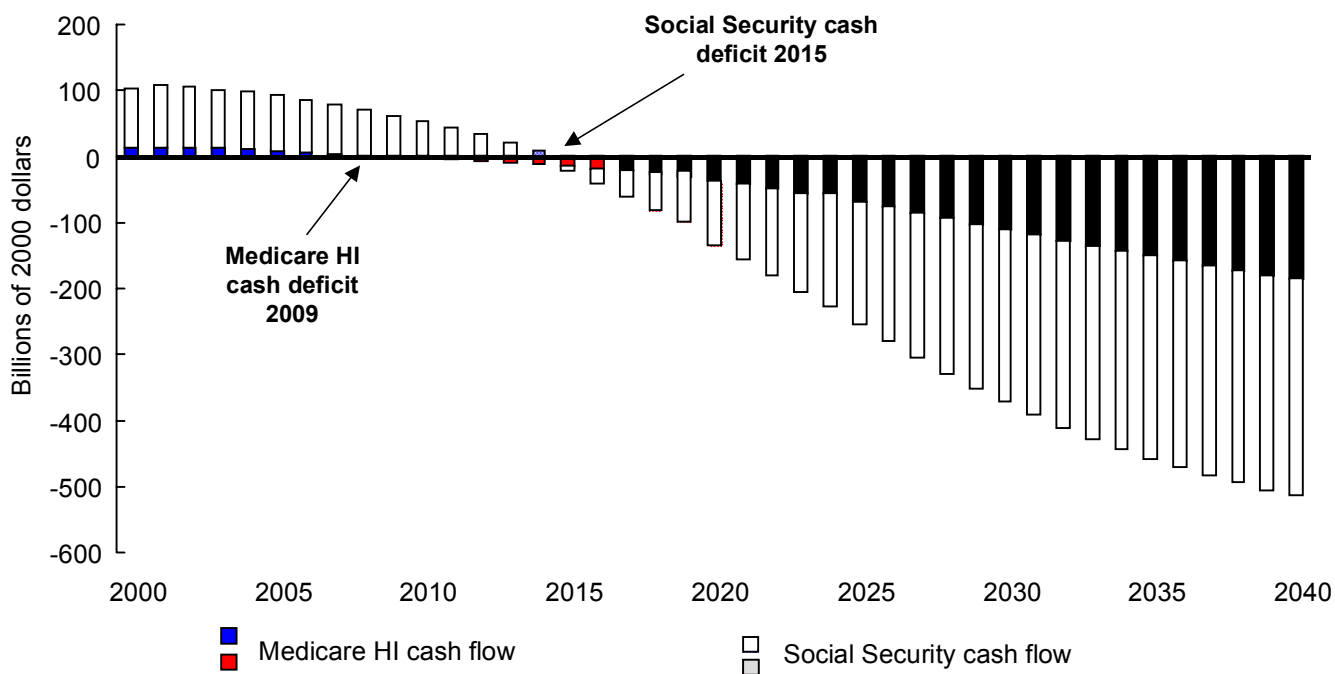
As I discussed earlier, reducing the relative future burdens of Social Security and health programs is critical to promoting a sustainable budget policy for the longer term. Moreover, absent reform, the impact of federal health and retirement programs on budget choices will be felt as the baby boom generation begins to retire. While much of the public debate concerning the Social Security and Medicare programs focuses on trust fund balances—that is, on the programs' solvency—the larger issue concerns sustainability. Absent reform, the impact of federal health and retirement programs on budget choices will be felt long before projected trust fund insolvency dates when the cash needs of these programs begin to seriously constrain overall budgetary flexibility.

The 2000 Trustees Reports estimate that the Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds will remain solvent through 2037 and the Hospital Insurance (HI) Trust Fund through 2025. This date does not incorporate either the technical panel's suggested higher cost growth assumption or any benefit expansions such as prescription drug coverage. Furthermore, because of the nature of federal trust funds, HI and OASDI Trust Fund balances do not provide meaningful information about program sustainability—that is, the government's fiscal capacity to pay benefits when the program's cash inflows fall below benefit expenses. From this perspective, the net cash impact of the trust funds on the government as a whole—not trust fund solvency—is the important measure. Under the Trustees' intermediate assumptions, the OASDI Trust Funds are projected to have a cash deficit beginning in 2015 and the HI Trust Fund a deficit beginning in 2009 (see figure 7). At that point, the programs become net claimants on the Treasury. In addition, as we have noted in other testimony,¹⁴ a focus on HI solvency presents an incomplete picture of the Medicare program's expected future fiscal claims; the Supplementary Medical Insurance (SMI) portion of Medicare,

¹⁴*Medicare Reform: Issues Associated with General Revenue Financing* (GAO/T-AIMD-00-126, March 27, 2000).

which is not reflected in the HI solvency measure, is projected to grow even faster than HI in the future.

Figure 7: Social Security and Medicare’s Hospital Insurance Trust Funds Face Cash Deficits as Baby Boomers Begin to Retire



Note: Projections based on the Trustees’ 2000 intermediate assumptions.

Source: GAO analysis of data from the Office of the Actuary, Social Security Administration and the Office of the Actuary, Health Care Financing Administration.

To finance these cash deficits, Social Security and the Hospital Insurance portion of Medicare will need to draw on their special issue Treasury securities acquired during the years when these programs generated cash surpluses. In essence, for OASDI or HI to “redeem” their securities, the government must raise taxes, cut spending for other programs, or reduce projected surpluses.

Our long-term simulations illustrate the magnitude of the fiscal challenges associated with our aging society and the significance of the related

challenges that government will be called upon to address. As we have stated elsewhere,¹⁵ early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. This message is not changed by the new surplus numbers. It remains true that the longer we wait to take action on the programs driving long-term deficits, the more painful and difficult the choices will become.

Moving From Balancing the Budget to Balancing Fiscal Risk

While these new surplus projections offer an opportunity to address today's needs and the many pent-up demands held in abeyance during years of fighting deficits, they do not eliminate our obligation to prepare for the future. Today's choices must be seen not only in terms of how they respond to today's needs, but also how they affect the future capacity of the nation and our ability to meet our looming demographic challenge.

When we looked at how other nations responded to budget surpluses, we discovered that most found a way to respond to pressing national needs while also promoting future fiscal flexibility and saving. Their actions could be seen as constituting a range of actions across a continuum by the degree of long-term fiscal risk they present. Figure 8 illustrates this array along one dimension. At one end debt reduction and entitlement reform actually increase future fiscal flexibility by freeing up resources. One-time actions—either on the tax or spending side of the budget—may neither increase nor decrease future flexibility—although here many would distinguish between types of actions; devoting funds to previously underfunded liabilities or to one-time capital investments may be seen as different than actions that increase consumption. Permanent or open-ended tax cuts and/or spending increases may reduce future fiscal flexibility—although that is likely to depend on their structure and implementation. For example, many would argue that certain permanent changes in the tax structure and/or funding for well-chosen investments can enhance economic growth and build for the future.

¹⁵Major Management Challenges and Program Risk: A Governmentwide Perspective (GAO-01-2421, January 2001), p. 45.

Figure 8: Array of Fiscal Choices

Reduce debt	Capital investments	One-time tax refunds	Permanent tax cut
Reserve funds	Address underfunded liabilities	One-time spending	Permanent spending increase
	Invest surpluses		

The decision on how to allocate surpluses is by its very nature inherently a political one—and I am not here to advocate any particular tax or spending proposal. Rather, my point is that since surplus projections are more uncertain than demographic trends, prudence would argue for seeking to balance risk. You might think about the budget choices you face today as a portfolio of fiscal actions balancing today’s unmet needs with tomorrow’s fiscal challenges. If the experience of other nations and the states is any guide, we will most likely choose actions across an array of choices. In thinking about balanced risk, it is not the merits of any individual proposal that are key but the impact of these decisions in the aggregate or from a portfolio perspective.

This suggests that whatever the fiscal choices made in allocating the surplus among debt reduction, tax cuts, and spending increases, approaches should be explored to mitigate risk to the long term. For example, provisions with plausible expiration dates—on the spending and the tax side—may prompt re-examination taking into account any changes in fiscal circumstances. A mix of temporary and permanent actions may also reduce risk. In our recent Performance and Accountability series, we also suggested that, given the inherent uncertainty of surplus projections, consideration be given to linking a portion of new fiscal commitments to the actual levels of surpluses achieved. As I mentioned earlier, one possible approach could be a kind of “surplus dividend” that had to be saved. Whatever the form, linking new commitments to actual results can be seen as a kind of contingency planning. Others have suggested considering a portion of the surplus as a kind of contingency fund.

Some states have developed approaches to limiting fiscal risk by linking temporary tax cuts or spending to actual fiscal results. In Ohio, an Income

Tax Reduction Fund was established as a mechanism to return surplus revenues to taxpayers based on the size of the actual surplus in excess of the amount required to maintain the budget stabilization fund. Minnesota has refunded surplus revenues beginning in 1997 and has since instituted a requirement that a revenue surplus exceeding 0.5 percent be designated for a tax rebate. Arizona developed triggers which designate the use of surplus revenues for specific tax reductions, or new appropriations based on the amount of actual surpluses achieved. Arizona also has increased the balances in the Budget Stabilization Fund. The excess surplus funds triggered reductions in vehicle license and corporate taxes as well as increased education funding.

Conclusion

Surpluses challenge our nation to move beyond a focus on reducing annual deficits to a broader agenda. They offer us an opportunity to look more closely at what government does and how it does business. With the advent of surpluses in the near-term, the nation needs to develop a new fiscal paradigm—one that will prompt greater attention to the long-term implications of current programs and policy choices and help to better balance today's wants against tomorrow's needs.

For more than a decade, budget processes have been designed with the goal of reaching a zero deficit. Now that goal has been reached—indeed passed. Clearly, the limits imposed to achieve a balanced budget are not working in the world of surplus. At the same time eliminating all controls would be a mistake. You face the need not only to make choices about tax and spending policy, but also to design a process for the future.

Now that the goal of “Zero Deficit” is gone, what should replace it? Whatever measure you select, we believe that the budget and the budget process must pay more attention to the long-term cost implications of today's budget and program decisions. We have recommended, for example, budgeting for the fully accrued costs for insurance and pensions in current budgets to reflect the future commitments made in current programs.¹⁶ Ultimately, the federal government needs a decision-making framework that permits it to evaluate fiscal good fortune and choices against both today's needs and the longer-term fiscal future we wish to hand to future generations.

¹⁶ *Accrual Budgeting: Experiences of Other Nations and Implications for the United States* (GAO/AIMD-00-57, February 18, 2000) and *Budget Issues: Budgeting for Federal Insurance Programs* (GAO/AIMD-97-16, September 30, 1997).

I have suggested here today that budget choices can be seen as a fiscal portfolio—and as such the ideal set would balance different types of fiscal risks. Not only should policy choices be examined individually, but also their aggregate impact on the nation’s long-term economic health should be considered. The budget surpluses before us offer policymakers the opportunity to strike a balance between addressing today’s needs and the obligation to hand a strong economy and sustainable fiscal policies on to our children, our grandchildren, and future generations.

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