CENTER ON BUDGET AND POLICY PRIORITIES

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"THE PERIL OF ZERO DEBT" AND THE LONG-TERM BUDGETARY OUTLOOK: SOME QUESTIONS REGARDING CHAIRMAN GREENSPAN'S RECENT TESTIMONY

The full report can be viewed at http://www.cbpp.org/2-22-01bud.pdf

On February 22**,** the Center on Budget and Policy Priorities released an analysis, "The Peril of Zero Debt and the Long-Term Budgetary Outlook: Some Questions Regarding Chairman Greenspan's Recent Testimony." This analysis evaluates the argument that Federal Reserve Chairman Alan Greenspan has advanced that because of the "peril of zero debt," a large tax cut is needed.

Chairman Greenspan noted that projected budget surpluses are sufficiently large that the public debt may be eliminated within the next ten years. At that point, continued surpluses would necessarily result in public investment in some sort of private assets (since there would be no debt left to pay down). Chairman Greenspan argued that public investment in private assets could lead to political interference in private capital markets and, as a result, would risk "sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise." This is the so-called "peril of zero debt." To avoid that peril, Greenspan recommended that projected surpluses be dissipated in part through tax cuts.

Dissipating the surpluses through tax cuts, however, would result in lower national saving than if the surpluses are saved by paying down debt (since the funds used for the tax cuts or spending increases would not be saved, while the funds used to pay down debt would be). Higher national saving offers significant benefits to the nation in preparing for the retirement of the baby boomers, since it raises the productivity of future workers and thereby reduces the burden of supporting the baby boomers in their retirement. Given these benefits of higher national saving, Chairman Greenspan's argument about "the peril of zero debt" merits careful scrutiny. A critical question is whether the economic costs associated with public investment in private assets outweigh the economic costs of failing to undertake as much national saving. The Center's analysis paper finds:

- Higher national saving — achieved by preserving a substantial portion of the projected budget surpluses — offers the most promising fiscal policy response to the need to prepare for the increased long-term costs of our aging population.

- Forgoing national saving to avoid any public investment in private assets would potentially entail economic costs. Saving the projected Social Security surplus, the projected Medicare surplus, and one-third of the projected on-budget surplus between 2002 and 2011 would increase the size of the economy (i.e., increase GDP) by roughly $70 billion (or about 0.5 percent) in 2012 relative to saving only

the Social Security surplus over the coming decade. By the end of 2011, our nation's capital stock (the resources that help us to produce income) would be $800 billion higher than if we saved only the projected Social Security surpluses. (These estimates are explained in the Center's paper.)

- Even if the projected budget surpluses fully materialize, and the majority of the surpluses is used to reduce debt or accumulate private assets, the size of projected public investment in private assets over the next ten years would be small in comparison to the investments already undertaken by state and local government pension funds in the United States and by foreign governments such as Denmark and Norway. State and local pension funds in the United States already own almost $2 trillion in corporate equities and have invested these amounts without any apparent damage to the economy. Denmark has successfully invested its public pension fund in private assets for decades.

- Public investments in private assets should be undertaken through the Social Security system. In investing Social Security reserves in equities, *no* Congressional or executive branch involvement should be allowed. Most proposals to allow a portion of Social Security reserves to be invested in private securities would establish an independent board tasked with selecting private investment managers. These managers — which could include entities such as Merrill Lynch, Vanguard, or State Street Bank — would undertake the investing of a modest portion of Social Security reserves in broad index funds in the equities markets. (An index fund reflects a collection of stocks.) Investments in individual stocks, rather than index funds, would not be permitted.

Given the experience of state and local government pension funds in the United States and of national governments in other countries in managing investments in private assets, and the protections that could be erected to avoid politicization of the capital markets from investments in private assets through the Social Security trust fund, the peril of zero debt does not provide a sound rational for enacting a large tax cut today. Passing a large tax cut merely to avoid the possibility of public investments in private assets would not represent sound policy.