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SHOULD THE BUDGET RULES BE CHANGED SO THAT LARGE-SCALE BORROWING TO FUND INDIVIDUAL ACCOUNTS IS LEFT OUT OF THE BUDGET?¹

By Jason Furman, William G. Gale, and Peter R. Orszag²

Recent plans to replace part of Social Security with individual accounts would significantly increase federal borrowing for at least several decades. Over the next 10 years alone, various individual account proposals funded by borrowing would increase deficits and borrowing by between \$1 trillion and \$5.3 trillion.

Such deficits have historically been acknowledged by supporters of individual accounts. For example, an analysis of Social Security individual accounts issued by the President's Council of Economic Advisers in 2004 concluded that "Personal retirement accounts widen the deficit by design — they refund payroll tax revenues to workers in the near term while lowering benefit payments from the pay-as-you-go system in later years."

Now, however, the Bush Administration and some Congressional leaders are considering a dramatic shift in the budget accounting rules that would cloak the impact of individual account plans on the deficit. Under the proposed shift, the borrowing associated with deficit-financed individual accounts would be omitted from the budget and would *not* show up as an increase in the deficit.

Those who favor this approach note that individual account proposals typically combine the creation of individual accounts today with a reduction of Social Security benefits decades into the future. They seek to obtain immediate budgetary "credit" for these future benefit reductions. But this radical departure from established budget rules would not be fiscally responsible. It should not be adopted, for four reasons:

- The proposed borrowing of several trillion dollars would require the government to go much more heavily into private credit markets over the next few decades and seek much larger amounts from domestic and foreign creditors. This should not be hidden through an accounting maneuver.

¹ For a fuller discussion of this issue, see Furman, Gale, and Orszag, "Should the Budget be Changed to Exclude the Cost of Individual Accounts," Center on Budget and Policy Priorities, December 13, 2004.

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- The claim that this large-scale borrowing would merely exchange future government debt for current government debt, and not affect the government’s overall financial condition, is not correct. The proposed financial maneuver could worsen the nation’s fiscal outlook, and it would significantly reduce the government’s fiscal flexibility.
- Leaving out of the budget the costs of borrowing large sums to fund individual accounts would open the door to “free lunch” Social Security plans, which hold appeal for politicians but undermine the underlying goals of Social Security reform, such as increasing national savings.
- Bending the rules to leave this borrowing out of the budget could establish a dangerous precedent for future budget gimmickry.

Large-scale Borrowing Should Not be Hidden

The public debt already is projected to grow from a level of 34 percent of the Gross Domestic Product (the basic measure of the size of the U.S. economy) in 2000 to nearly 70 percent of GDP by 2030. The borrowing called for under the principal plan advanced by the President’s Social Security Commission would raise the debt to nearly 100 percent of GDP by 2030. The debt would be raised to even higher levels under some other individual account plans. These elevated levels of debt would significantly increase the risk of a crisis in which the government faces difficulty paying the interest on this debt or issuing new debt in the bond market. The borrowing that would create this fiscal situation should not be omitted from, or obscured in, the federal budget.

Advocates of leaving these large borrowing costs out of the budget respond by arguing that the borrowing to establish individual accounts would merely create “explicit debt” today (in the form of new Treasury bonds) in exchange for “implicit debt” that the federal government has already incurred (in the form of benefit promises to future Social Security beneficiaries that exceed the future revenues that Social Security will receive under current law). They argue that these two types of debt — “implicit” debt and “explicit” debt — are essentially the same, and that converting implicit debt to explicit debt thus is not an increase in overall debt and need not be included in the budget.

This argument is seriously flawed, however. The two types of debt are decidedly *not* the same, and converting implicit debt into explicit debt could worsen the nation’s fiscal outlook and would reduce the government’s fiscal flexibility.

Table 1

Debt Held by the Public Under Individual Account Plans (Percent of GDP)				
	2000	2010	2020	2030
CBO Baseline	34%	39%	43%	69%
Commission Model 2	34%	46%	61%	97%
Ferrara / Ryan-Sununu	34%	54%	88%	144%
Calculations based on CBO, 12/2003, <i>The Long-Term Budget Outlook</i> , Scenario 2 and memoranda from the Office of the Actuary, Social Security Administration.				

Explicit” Debt and “Implicit” Debt

The explicit debt that would be incurred would have to be bought by creditors in financial markets; the federal government would have to borrow much more in financial markets over the next few decades than would otherwise be the case. By contrast, the “implicit debt” associated with future Social Security benefit promises does not have to be financed in financial markets in coming decades — and might not have to be financed even after that, because the implicit debt could, and likely would, be reduced through future policy changes. In 1983, Social Security faced a large implicit debt; benefits would soon exceed the revenues to pay them and would continue to do so indefinitely. Congress and the President acted — they changed Social Security benefits and taxes and did so *without* borrowing new money — and the implicit debt was substantially reduced. The same is likely to occur with regard to future unfunded Social Security promises.

Once explicit debt is incurred, by contrast, and Treasury bonds are issued, the government is stuck with the debt, unless it can shrink or eliminate the debt by raising taxes or cutting programs *immediately*. In other words, while a change in taxes or benefits that gradually takes effect in the future can reduce implicit debt (which essentially is *potential* debt that has not yet been incurred), future policy changes cannot reduce today’s explicit debt. It also should be noted that a government burdened by a large explicit debt that loses the confidence of financial markets must cut programs or raise taxes now, and immediate adjustments of this nature can be wrenching.

Moreover, despite their proponents’ claims, individual account plans might not even substantially reduce the *implicit* debt. The borrowing proposed to fund individual accounts is assumed by its proponents to be “paid for” by reductions in Social Security benefits that would not start taking effect for a long time and would not be in full effect until many decades into the future. When those changes were about to bite, political pressures might build to undo them. The future benefit reductions might not actually materialize.

The Lessons of Recent History

The history of the past decade is instructive in this regard. Over the past decade, at least three major program reductions enacted into law — reductions in farm price supports, reductions in certain Medicare provider payments, and reductions in military retirement benefits — were reversed in whole or substantial part before they took effect. The reversal of these measures has increased deficits and the debt by tens of billions of dollars.

If several trillion dollars are borrowed to establish individual accounts in exchange for Social Security benefit reductions that are slated to take effect decades from now, but those benefit reductions are subsequently scaled back by future Congresses, the net result could be an *increase* in the government’s liabilities. If that occurred, Social Security “reform” could make the government’s already dismal long-term fiscal outlook even worse.

Opening the Door to “Free Lunch” Plans

Leaving the borrowing for individual accounts out of the budget — and pretending it has no effect on the deficit — would likely increase the attractiveness of “free lunch” Social Security reform proposals. Such proposals purport to restore Social Security solvency without raising

payroll taxes or reducing benefits. Free-lunch plans restore solvency without making hard choices by pouring in massive amounts of borrowed money. Under longstanding budget rules, the Achilles heel of free-lunch plans is that they substantially increase the reported federal budget deficit. Hiding the budgetary impact of large-scale borrowing to fund individual accounts, however, could create a *carte blanche* for free-lunch plans. This would be particularly dangerous, since free-lunch plans hold a natural appeal for politicians.

“Free lunch” individual account plans go against the longstanding consensus that any Social Security reform should increase national savings and thereby increase investment and economic growth and make it easier to meet obligations to future generations. Individual accounts will fail to add to national savings if the new savings the accounts represent are deficit-financed through government borrowing. (National savings equals private savings *minus* government deficits, which soak up a portion of private savings and thereby reduce the overall amount of savings available for investment in the economy.³) In addition, if people conclude that having individual accounts means they can safely reduce other retirement savings, then individual accounts financed by government borrowing will actually *reduce* national savings, since the amount that the government borrows will exceed the net amount of new savings.

Creating a Precedent for More Budget Gimmickry

There is no shortage of spending and tax proposals in other parts of the budget that are justified by their proponents as producing long-term budgetary benefits. Bending the budget rules to make it look like borrowing for individual accounts would have no effect on deficits, on the grounds that the cost will be offset by savings in distant decades, would set a worrisome precedent. It could lead over time to the use of other, comparable budgetary maneuvers. For example, a large tax cut could be coupled with either an implausibly large tax increase not slated to take effect for decades or an unspecified, large reduction in future discretionary spending. Proponents of the tax cut could argue it had no net cost because of the subsequent offsets, even if the offsetting changes would not take effect for many years and might never materialize (since future Congresses might reverse them).

The Responsible Approach: Do Not Bend the Budget Rules

For these reasons, the best approach is *not* to bend the budget rules in a politically convenient fashion, but rather to continue to adhere to the current, well-established rules. Bending the rules to omit up to several trillion dollars of borrowing from the budget could undermine confidence in the accuracy and integrity of the budget. It could unsettle financial markets, both as a result of the large increase in the government’s demand for credit and by lessening investor confidence in the reliability of federal budget reporting and the soundness of the nation’s fiscal policy course.

It should be noted that an increase in the near-term deficit is not necessary to reform Social Security or even to create individual accounts. Long-term balance can be restored to Social Security through modest revenue and benefit adjustments that start to *reduce* the deficit within the next 10 years. Several Social Security plans that would accomplish this have been put

³ If governments run budget surpluses, national savings equal private savings *plus* government surpluses (which essentially are public savings).

Table 2

Ten-Year Costs of Social Security Proposals to Restore Long-term Social Security Solvency	
Proposal	10-Year Cost (FY2006 - FY15)
<u>Non-individual Accounts Plans Reduce Short-run Deficit</u>	
Diamond-Orszag plan	-\$0.6 trillion
Ball plan	-\$0.3 trillion
<u>Individual Accounts Plans Increase Short-run Deficit</u>	
Kolbe-Stenholm plan	\$1.0 trillion
President's Commission Model 2 (assuming 66.7% participation)	\$1.4 trillion
President's Commission Model 2 (assuming 100% participation)	\$2.2 trillion
Ryan-Sununu bill (based on Ferrara plan)	\$5.3 trillion
Note: Costs based on memoranda from the Office of the Actuary, Social Security Administration, available at http://www.ssa.gov/OACT/solvency/index.html . The actuary's estimates are converted from constant dollars to current dollars using the Social Security Trustees CPI projections.	

forward, such as a plan designed by Peter Diamond and Peter Orszag and a plan by former Social Security Commissioner Robert Ball. Nor does the substitution of individual accounts for part of Social Security necessitate massive borrowing and large increases in current deficits. Individual accounts could be financed through new worker contributions, as under a plan put forward by economist Edward Gramlich (currently a member of the Federal Reserve's Board of Governors and previously the chair of the 1994-6 Advisory Council on Social Security), or by making concurrent adjustments in other federal taxes or spending (that is, by raising other taxes or cutting other programs to provide the funds to transfer to the individual accounts). Indeed, it is the *rejection* of such approaches that is leading the Administration and a number of individual-account proponents to propose massive government borrowing, accompanied by an effort to cloak the effects of that borrowing by omitting it from the budget.