Budget –
1999 –
GOP

CENTER ON BUDGET AND POLICY PRIORITIES

March 19, 1999

THE REPUBLICAN BUDGET PROPOSALS

By Robert Greenstein

Summary

The Senate and House Budget Committees this week approved budget resolution proposals that closely resemble each other. In addition, Republican Congressional leaders announced last week that they will seek enactment of a Social Security "lock-box" proposal; this proposal has since been unveiled by Senator Spencer Abraham.

In combination, the budget resolutions and the lock-box proposal are presented as preserving and protecting Social Security (and doing more for it than the Administration's proposals) and promoting fiscal responsibility, while still providing a substantial tax cut. Close examination reveals, however, that the budget plan and lock-box measure would not meet all of these goals and contain a number of surprising — and in some cases, disturbing — features.

Of particular note, these proposals could lead to very little debt reduction. Moreover, the large tax cuts the budget resolutions contain, in conjunction with a failure to ensure that meaningful debt reduction occurs, could lead to dangerously high deficits when the baby-boom generation retires.

Long-term budget forecasts indicate that under current law, budget surpluses will continue growing only through about 2012. After that point, the surpluses will gradually begin to recede. The tax cuts in the budget resolutions, however, would grow explosively in the latter years of the 10-year budget period that Congress uses (2000-2009) and keep growing in cost after that (unless some of the tax relief is canceled at that point). Thus, not only would the tax cuts consume most of the non-Social Security surplus over the next decade, but the tax cuts' cost almost certainly would be larger than the entire non-Social Security surplus at some point not long after 2009, throwing the non-Social Security budget back into deficit. Averting such an outcome would entail still-deeper cuts in programs in those years than the steep and unrealistic cuts the budget resolutions contain.

In addition, the lock-box proposal is constructed so Social Security surpluses can be used to finance individual retirement accounts rather than pay down debt. The lock-box proposal has evidently been designed in this manner to accommodate Social Security legislation that Republican leaders are now developing, which is expected to use the majority of the Social Security surpluses over the next decade for this private

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accounts. The projections of the Social Security actuaries show that the Social Security surpluses themselves will stop growing and start receding in the five years after 2009. Since the costs of the individual accounts in the legislation being developed would necessarily continue to mount in those years, there is substantial risk that this approach would result in costs for individual accounts that exceed the entire Social Security surplus and add further to re-emerging deficits — and begin to do so in the same years that the costs of the swelling tax cuts exceed the *non*-Social Security surplus.

The combination of tax cuts that ultimately exceed the non-Social Security surplus and individual accounts whose costs surpass the size of the Social Security surplus, along with the continuation of high interest payments on the debt (because little of the debt would have been paid down), would pose dangers for the nation, coming just as the baby boomers are beginning to retire in large numbers.

- The lock-box proposal would not ensure that the debt held by the public is reduced. The proposal would allow Social Security surpluses to be borrowed and used to establish a large new entitlement in the form of individual accounts, rather than being used to pay down the debt. Under the lock-box proposal, if Social Security surpluses are used to fund individual accounts rather than to pay down the debt, the debt limits are automatically adjusted upward.

- The Social Security plans now emerging in Republican leadership circles appear to envision using the bulk of the Social Security surpluses to fund individual accounts. The Social Security proposal that Reps. Bill Archer and Clay Shaw are developing, with the House leadership's blessing, as well as the plan Senator Phil Gramm has crafted, would establish individual accounts without reducing Social Security benefits. Such plans require large amounts of additional funding. These new funds could not come from the *non*-Social Security surplus, since the vast majority of that surplus would be used for tax cuts. This leaves only one source for funding these accounts — the Social Security surpluses.

- Under the emerging Republican approach, the Treasury would borrow the Social Security surpluses each year, provide bonds to the trust funds in return, and use the bulk of these surpluses to make deposits into individual accounts. (This is essentially the same type of mechanism that some Members of Congress have criticized as "double counting" when discussing the Administration's Social Security plan.) This is why the lock-box proposal provides for automatic increases in the debt limits if the Social Security surpluses are used to finance individual accounts. [1]

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[1] This evidently also is the reason that the House budget resolution automatically raises the spending (continued...)

The Tax Cuts

While the bulk of the Social Security surpluses could be used to fund individual accounts rather than reduce the debt, the vast bulk of the non-Social Security surpluses would go for large tax cuts. The tax reductions the budget resolutions contain would grow extremely rapidly in the latter part of the 10-year budget period.

- The tax cuts would lose $142 billion in revenue in the first five years, but $636 billion in the second five years. In other words, they would cost 4 ½ times as much in the second five years as in the first five.
- The tax cuts would cost approximately $50 billion in 2004, more than $100 billion by 2006, slightly over $150 billion in 2008, and $177 billion in 2009. Tax cuts with costs that grow this explosively would necessarily continue growing in cost after the 10-year budget window ends.

Within a few years after 2009, the tax cuts reflected in the budget resolution would become sufficiently large that they would exceed the entire non-Social Security surplus projected for those years. Even if the tax cuts grew only in tandem with the economy (i.e., at the same rate as the Gross Domestic Product) in the years after 2009 — which would be unlikely since the tax cuts are slated to grow at several times the rate of GDP growth in the years through 2009 — they still would cost *more than $1 trillion* in the five years from 2010 to 2014 and would exceed the size of the non-Social Security surplus within a few years. With the tax cuts continuing to grow while the surplus ceased to grow and began to recede, deficits in the non-Social Security budget would re-emerge.

Indeed, CBO's long-term forecast shows that if *none* of the budget surpluses are used for tax cuts or program expansions, with *all* of the surpluses being devoted to paying down the debt, deficits in the unified budget will return some time between 2020 and 2030. By using most of the non-Social Security surplus for burgeoning tax cuts and paving the way to use much of the Social Security surplus for private retirement accounts — rather than for paying down debt — the budget plans would cause deficits to return much sooner, and climb substantially higher, than the CBO forecast projects.

These deficits would return sooner and climb higher not only because of the cost of the tax cuts and the individual accounts, themselves, but also because interest payments on the debt — now more than $200 billion a year — would remain high, since little of the debt would have been paid down. The opportunity to eliminate most or all

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[1] (...continued)
allocations given to the House Ways and Means Committee if that Committee uses the Social Security surpluses for individual accounts or similar purposes.

of the publicly-held debt before the baby boom generation retires in large numbers would be foregone.

Cuts in Discretionary Programs

To help accommodate the tax cuts, the budgets the Senate and House Budget Committees have approved would require radical shrinkage of some parts of the federal government. Not only would the budget plans maintain the stringent caps the 1997 budget agreement placed on discretionary (i.e., non-entitlement) spending for years through 2002 — which themselves would require sizeable reductions in discretionary spending in the next several years — but the budgets call for large additional reductions in non-defense discretionary programs in the years after that.

- The Senate and House budget resolutions include approximately $200 billion in additional reductions in discretionary programs between 2003 and 2009, on top of the reductions that would result from enforcing the caps through 2002 and allowing discretionary spending to rise only with inflation after that. (The standard baselines that CBO and OMB use to project federal expenditures and budget surpluses over the next 10 years assume the discretionary caps will remain in place through 2002 and that discretionary spending will keep pace with inflation after that.) These additional reductions in discretionary programs provide room for the tax cuts in the budget resolutions to be larger than otherwise would be possible.

- The cuts the Senate Budget resolution contains in non-defense discretionary programs are so large that by 2009, overall non-defense discretionary spending would be 28 percent below its FY 1999 level, adjusted for inflation.[2] Under the House resolution, the reduction in non-defense discretionary programs would be 29 percent by 2009. These deep cuts would occur although non-defense discretionary spending already constitutes as small or smaller a share of the Gross Domestic Product than in any year since 1962.

- The Senate resolution emphasizes the Republican leadership's intention to protect or increase funding for large areas of non-defense discretionary spending, including highway and mass transit spending, crime programs, veterans health programs, elementary and secondary education, and research at the National Institutes of Health. Since *total* non-defense

[2] The FY 1999 level used here as a point of reference excludes emergency spending. If emergency spending were included, the dimensions of the discretionary cuts in the budget resolution would seem deeper.

discretionary spending would fall 28 percent to 29 percent in purchasing power by 2009 while significant areas of the non-defense discretionary budget were shielded from cuts or increased, the remainder of the non-defense discretionary budget would have to be cut substantially more than 28 percent to 29 percent.

Reductions of this magnitude in discretionary programs seem unrealistic. If the tax cuts are enacted and the lock-box is in place, however, it could be difficult to escape such deep reductions. The tax cuts would cause most of the non-Social Security surpluses projected for the next 10 years to disappear. This means that if attempts were subsequently made to boost discretionary spending to higher levels, such efforts could be stymied by the lock-box. The lock-box effectively bars unbalanced budgets through 2009 in the non-Social Security part of the budget, and restoring some of the cuts the budget plans would make in discretionary programs could push the budget out of balance.

By consuming the non-Social Security surpluses, the tax cuts also would largely preclude use of any sizeable share of the surplus to help shore up Medicare (or to meet other unaddressed needs). Most analysts familiar with Medicare's daunting financing problems believe that a combination of substantial Medicare reforms and sizeable new resources will be necessary if long-term Medicare solvency is to be restored.

Other Risks Posed by the Lock-box Proposal

Adding to these concerns, the lock-box bill could make it harder for the federal government to manage the economy effectively and keep it out of recession. The bill sets limits on the allowable levels of debt held by the public; these limits assume the non-Social Security budget is in balance throughout the next 10 years. If the budget slipped out of balance, the Treasury would be barred from borrowing funds (from either the public or the Social Security trust funds) unless three-fifths of the Senate and a majority of the House so approved.

Under the lock-box bill, budget cuts or tax increases would be required when the economy weakened. This would be true because when the economy slows, expenditures rise and revenues decline (or grow more slowly). An economic slowdown consequently would cause the debt limits the lock-box bill sets to be exceeded, unless budget cuts or tax increases were enacted. Cutting government expenditures or raising taxes while the economy is faltering, however, is the reverse of what sound economy policy would prescribe. Doing so would risk pushing a weak economy into recession and making recessions deeper.

The lock-box proposal also poses other dangers. If a slowing economy threatened to cause the debt limits to be exceeded, but Congress and the President could not reach agreement in time on budget cuts or tax increases to avert that — and a

three-fifths majority could not be amassed in the Senate to raise the debt limit — crisis would loom. The Treasury would have to default on government obligations or hold up government payments to beneficiaries and government contractors. Until now, it has taken a simply majority of Congress to raise the debt limit, and it often has proved hard to achieve a majority of that type. Securing a *three-fifths* vote in the Senate to raise the debt limit could prove excruciatingly difficult.

The proposal consequently would increase the potential of a government default and an interruption of vital government expenditures. CBO has warned that even a default lasting only a few days could have enduring consequences, because it could undermine confidence in the binding nature of the financial obligations of the U.S. Government and could raise government interest and contracting costs as a result.

These concerns do not suggest that a lock-box designed to prevent use of Social Security surpluses for other purposes is unwise. Rather, they indicate that any such lock-box legislation should be designed so that it does not risk precipitating a recession or a government default. These issues are discussed in more detail in a separate Center analysis, "The Lock-Box Proposal and the Economy."

Does the Budget Lock Up Social Security Surpluses to Pay Down the Debt?

The lock-box bill would write into law sharply declining limits on the publicly held debt. These limits would be set for the next 10 years and would track CBO's current projections of what the publicly held debt will be in that period if the non-Social Security budget is in balance and Social Security surpluses are used exclusively to pay down the debt.

These debt limits would be adjusted automatically in two circumstances. First, the debt limits would be reduced or raised to the extent that annual Social Security surpluses turned out to be larger or smaller than CBO had projected. Second, the debt limits would automatically be raised to the extent that Social Security reform legislation is enacted that uses some of the Social Security surpluses in a manner that makes these funds unavailable for paying down the debt, such as by funding individual accounts. (The debt limits would *not* be raised if Social Security surpluses were used to raise Social Security benefits.)

This second exception is of major importance. It is the reason that the proposal would enable Congress to bypass debt reduction and use the lion's share of the surpluses to fund individual accounts instead.

Republican leaders (especially in the House) have said that in coming weeks they plan to unveil a Social Security proposal to create government-funded private retirement accounts without cutting Social Security benefits. House Ways and Means

Committee chair Bill Archer and Social Security Subcommittee chair Clay Shaw have indicated they plan to release such a proposal shortly. Senator Phil Gramm plans to introduce a somewhat similar proposal in the Senate. Both plans are based on the Social Security proposal that economist Martin Feldstein has fashioned.

The Feldstein plan entails the expenditure of trillions of dollars over the next several decades to create individual accounts without cutting Social Security benefits. The expenditure of these funds is necessary under the Feldstein plan because it is not possible to create individual accounts without cutting Social Security benefits unless large sums of new money are provided, at least for a number of decades. In an analysis issued last December, the Social Security actuaries estimated that the version of the Feldstein plan then in circulation would cost the government *$6.4 trillion over the next 25 years.*[3] (The latest version of the Feldstein plan would cost somewhat more than that, because its individual accounts are larger and more expensive than the accounts contained in the version of the plan the actuaries examined.[4])

From whence would these trillions of dollars come? They could not come from the *non*-Social Security surplus, since it would largely be consumed by tax cuts under the Republican budget resolution. There would be only one way to finance the large sums these individual accounts would require — by having the Treasury use most of the projected Social Security surpluses for the private accounts.

The Return of "Double-Counting"

Under what appears to be the plan the Republican leadership is developing, the Treasury would take the surplus Social Security revenues from the Social Security trust funds each year and give bonds to the trust funds in exchange. The Treasury then would use the borrowed money a second time. But instead of the principal "second use" of these funds being, as under the Clinton plan, to buy back Treasury bonds from the public and deposit them in the Social Security trust funds (thereby reducing the publicly held debt), the second use of most of these funds would be to establish private accounts. This is the reason the lock-box proposal calls for the ceiling on the publicly held debt to be increased automatically if Social Security reform legislation uses Social Security surpluses for purposes other than paying down debt.

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[3] Stephen C. Goss, Deputy Chief Actuary, Social Security Administration, "Long-Range OASDI Financial Effects of Clawback Proposal for Privatized Individual Accounts," December 3, 1998.

[4] The plan the actuaries examined required the government to deposit an amount equal to two percent of a worker's wages into the worker's account each year. The new version of the Feldstein plan requires the government to deposit 2.3 percent of wages — 15 percent more — into a worker's account.

This aspect of the Republican plan has significant budgetary implications. If the bulk of the Social Security surpluses are used for private accounts, little debt reduction will occur.

Tables in the documents accompanying the budget resolutions the Senate and House Budget Committees approved this week portray the debt held by the public as declining sharply under these budgets. These displays may prove to be misleading, however, as they assume the Social Security surpluses are used only to pay down debt. These displays do not reflect the impact of the soon-to-be-unveiled Social Security proposals that entail using the bulk of these surpluses for individual accounts instead. (It should be noted that the lock-box proposal would require all Social Security surpluses to be devoted to debt reduction if no agreement is reached on Social Security legislation.)

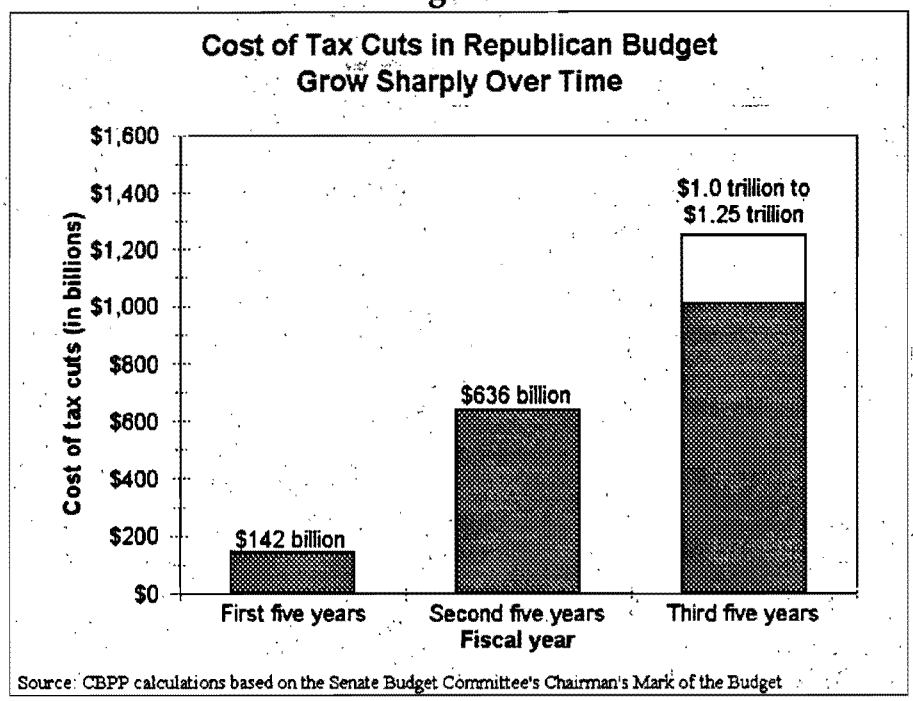
Why These Long-Term Fiscal Concerns are Important

CBO's long-term forecast shows that if *all* of the budget surpluses are used to pay down debt, with none of them used for program expansions or tax cuts, deficits will re-emerge in the unified budget between 2020 and 2030 and climb over succeeding decades to levels unprecedented for periods other than wars or recessions. CBO has cautioned that if most of the budget surpluses *are* used to expand programs and cut taxes rather than to pay down debt, deficits will return considerably earlier than this and climb even more rapidly.

The Republican budget framework entails using the vast majority of the non-Social Security surplus for tax cuts and contemplates using most of the Social Security surplus for individual accounts. Under such a scenario, little of the surplus would be used to reduce debt. Instead of the debt held by the public being eliminated by 2012 — as CBO forecasts will occur if all of the surpluses are used for debt repayment — and by about 2018 under the Clinton plan, the publicly held debt would remain large when the baby boomers begin retiring. We would have to continue spending a few hundred billion dollars a year on interest payments on the debt.

While continuing to have to make these interest payments, the government would have a smaller revenue base because of the tax cuts. As noted earlier, the tax cuts in the budget resolutions would themselves likely push the non-Social Security budget back into deficit before 2015. The tax cuts would cost $142 billion in the first five years and $636 billion in the second five years. If the cost of the tax cuts simply continued to grow after 2009 by the same average dollar amount as it would grow from 2003 to 2009, *the cost of the tax cuts for the five years from 2010 through 2014 would be $1.25 trillion*. Even if the growth in the cost of the tax cuts somehow could be held after 2009 to the rate of growth of the Gross Domestic Product, a feat that likely would entail taking back some of the tax cuts at that time, the revenue loss still would be exceed $1 trillion in the years from 2010 through 2014. (See Figure 1.)

Figure 1



Although the cost of the tax cuts would grow in the years after 2009, the non-Social Security surplus would not continue to enlarge. Long-term budget projections based on the CBO forecast indicate that the non-Social Security surplus will stop growing after about 2012 and begin to contract. As a result, the cost of the tax cuts would soon exceed the projected non-Social Security surplus, causing deficits to return in the non-Social Security budget.

The cost of the individual accounts expected to be included in the Republican Social Security proposals also would increase federal spending substantially in these years. The Feldstein plan, which apparently forms the model for the emerging Republican Social Security proposals, entails net expenditures of more than $300 billion a year by 2015, $400 billion a year by 2020, and $500 billion a year by 2025. [5] Under the Feldstein plan, the cost of the individual accounts would exceed the size of the Social Security surplus by sometime before 2015.

These added retirement-benefit costs would have to be shouldered despite the fact that the government already would face record deficits after the baby boomers retire, would have to make large interest payments on the debt (because little of the debt would have been paid down), and would be collecting less in revenue (because of the tax cuts). The net result would be deficits substantially larger than the deficits CBO forecasts for this period. Such deficits could be averted only by a fairly radical scaling

[5] These figures are based on estimates by the Social Security actuaries. They include debt service costs.

Tax Devices Could Aggravate These Problems

The budget plan could lead to the use of tax devices that enable the tax cuts in the next couple of years to be larger than would otherwise be possible. The budget resolution contains no *net* tax cut in 2000 and a net tax cut of only $7.4 billion in 2001. (The gross tax cuts would be about $15 billion in these years.) Senate Majority Leader Trent Lott and other Congressional leaders have spoken in recent weeks of designing certain tax cuts — such as capital gains cuts and expansions in IRA tax breaks for upper-income individuals — in such a manner that these tax cuts would *raise* revenue in their first few years. That could be accomplished by accelerating tax receipts into these years that otherwise would be collected in later years. The temporary increase in revenues would be used to finance larger tax cuts in the next few years than could otherwise be accommodated.

Much of the revenue losses that such devices would cause in subsequent years would occur *outside* the 10-year budgeting period. This is another reason the cost of the tax cuts would likely keep growing significantly after the end of the 10-year budget period.

back of the functions the federal government performs or by hefty tax increases. (Some may think that Social Security proposals involving individual accounts would ease these problems by adding to national saving and thereby promoting economic growth. The appendix at the conclusion of this paper explains why such proposals do not address the serious long-term fiscal problems identified here.)

Some critics of the Administration's proposals have criticized it for not making the hard choices on Social Security benefits and revenues needed to reduce the amounts by which Social Security benefit costs will exceed Social Security payroll tax revenues in future decades, and thus not doing enough to ease pressures on the rest of the budget at that time. The emerging Republican plan is a much more serious offender on these grounds. When the emerging Republican Social Security plans are taken into account, the Republican proposals would require the government to spend more on *both* retirement benefits for the elderly and interest payments on the debt than the amounts that would be expended under the Administration's plan, while collecting less in revenue to cover these costs.[6]

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[6] Under the Feldstein plan, the Social Security benefit structure would remain intact. The plan entails that once retirees begin drawing income from their individual accounts, Social Security benefits would be reduced $3 for every $4 received from such an account.

The Social Security actuaries examined the Feldstein approach under several sets of assumptions. Under the most optimistic assumptions used, the actuaries projected that the plan would result in net increases in federal costs (over those that would be incurred if the current Social Security benefit structure is maintained intact) every year through 2051. Under less optimistic assumptions, the plan would increase government costs every year for the next 75 years.

Does the Plan Do More for Social Security?

A claim made in support of the proposals described here is that they would "do more for Social Security" than the Administration's proposals. For two reasons, this claim does not stand up.

This claim stems from the fact that under the Clinton plan, the Treasury would continue for the next six years to use a modest portion of Social Security surpluses to help fund other government programs. Although the bulk of Social Security surpluses would go to pay down the debt held by the public during this period, an average of about $28 billion a year of these surpluses — or about $170 billion over the next six years — would be used to fund other government operations. The Republican lock-box bill would forbid this use of Social Security surpluses. This is the basis for the claim that the Republican plans would do more for Social Security than the Clinton proposals.

This claim overlooks the fact, however, that the Republican lock-box proposal would not result in the trust funds having any more assets, while the Clinton proposal would not result in the trust funds having fewer assets. That under the Clinton plan an average of $28 billion a year of Social Security surpluses would be used to help fund other government programs does not mean the trust funds would have $28 billion a year less in Treasury bonds. When the Treasury borrows surplus revenues from the Social Security trust funds, as it does every year, it provides the trust funds with Treasury bonds in return. The trust funds receive *the same amount of bonds* regardless of whether Treasury then uses these surplus Social Security revenues to help fund other government programs or to pay down debt. Under the Administration's plan, an average of $28 billion a year would be used to help fund other programs rather than to pay down debt, but the trust fund balances would not be affected.

To be sure, the fact that not as much debt would be paid down in the next few years because of the use of the $28 billion a year for other programs is not without consequences. But that is not a matter that would directly affect the assets or solvency of the Social Security trust funds. It also may be noted that this use of a portion of the Social Security surpluses to help fund other government operations would end after the sixth year, under the Clinton plan. In the years after that, the plan devotes sufficient amounts of the surpluses to debt reduction to make up for the effects on the accumulated debt of using some of the Social Security surpluses to fund other government operations during the first six years.

The other reason that the claim that the Republican proposals would do more to bolster Social Security more is not correct is that it overlooks the fact that the Administration would shift $2.8 trillion dollars in *additional* assets into the Social Security trust funds over the next 15 years, above and beyond the assets the trust funds otherwise will hold as a result of the Social Security surpluses over this period. The Social Security actuaries project these additional assets would extend the year in which Social Security becomes insolvent by 23 years, from 2032 to 2055.

By contrast, the Republican budget and lock-box proposals do not provide additional assets to the trust funds or extend the year in which Social Security would become insolvent. Under them, as under current law, Social Security would become insolvent in 2032. On the other hand, the Social Security reform legislation that Rep. Archer and other Republican leaders are developing may restore Social Security solvency for a longer period, such as for 75 years.

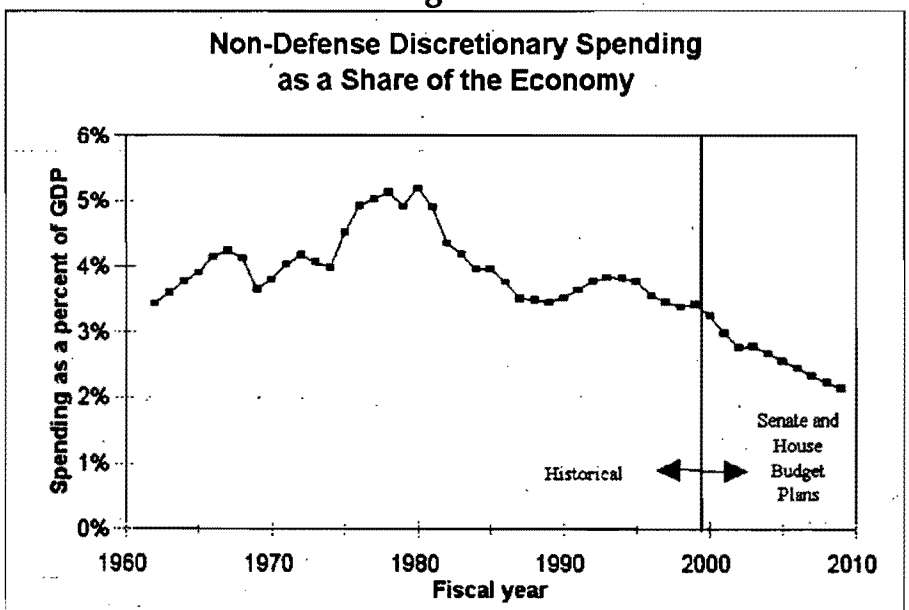
Tax Cuts and Discretionary Programs

The large tax cuts would be accompanied by deep reductions in domestic non-entitlement programs. The budget plans retain the stringent caps that the 1997 budget agreement placed on overall expenditures for discretionary (i.e., non-entitlement) programs, a category of the budget that includes both defense and domestic programs. The caps require substantial reductions in overall discretionary spending in the next few years.

The budget resolutions also call for increases in defense spending. To boost defense spending while keeping overall discretionary spending within the tight discretionary caps requires cutting domestic non-entitlement programs heavily between now and 2002. Under the House and Senate budget resolutions, expenditures for non-defense discretionary programs in fiscal year 2002 would be 18 percent — or $62 billion — below the 1999 level, as adjusted for inflation.[7] Because major areas of the non-defense discretionary budget could not — or would not — be reduced 18 percent, if they were reduced at all, the remaining parts of the non-defense discretionary budget would have to be cut more sharply than that.

After 2002, the cuts in non-defense discretionary programs would deepen further. Overall funding for non-defense discretionary programs would rise modestly

Figure 2



Sources: Budget of the United States, Fiscal Year 2000; Senate Budget Committee, Chairman's Mark of the Budget Resolution for FY 2000.
Note: 1962 is the earliest year for which this breakout is available.

[7] The FY 1999 levels used here do not include emergency spending.

between 2002 and 2004 but then be frozen for five consecutive years, falling in purchasing power due to the effects of inflation. By 2009, non-defense discretionary spending under the Senate budget resolution would be 28 percent below the fiscal year 1999 levels, adjusted for inflation. The reduction would be 29 percent under the House resolution.

The budget plans call for certain favored areas of non-defense discretionary spending — including highways, mass transit, elementary and secondary education, crime programs, veterans health programs, and NIH research — to be protected and, in some cases, increased. As a result, by 2009, the rest of the non-defense budget would apparently have to be cut 35 percent to 40 percent below the FY 1999 levels, as adjusted for inflation.[8] These deep cuts would occur even though non-defense discretionary spending already comprises as small or smaller a share of the economy than at any point in nearly four decades. (See Figure 2.)

Conclusion

The nation faces budget decisions of unusual importance this year. While the budget decisions made in a normal year usually have significant effects for one or several years, the decisions made this year could have large consequences for decades.

The emerging Republican budget and Social Security proposals risk exacerbating the serious fiscal problems the nation faces when the baby-boom generation retires. These proposals would squander a historic opportunity to reduce sharply or eliminate the debt held by the public, with the result that we could be burdened with obligations to continue making large interest payments on the debt far into the next century. These proposals also would establish what would effectively be a large new entitlement for retirees in the form of individual accounts, while shrinking the federal revenue base.

In addition, the budget proposals would require cuts of stunning depth in non-defense discretionary programs. Due to the magnitude of these cuts, some programs that constitute public investments and hold promise of improving productivity — and hence economic growth — could face the knife, as could many programs to aid the most vulnerable members of society.

The course these proposals chart is a troubling one. It constitutes a high-risk undertaking that is not consistent with building a sounder fiscal structure in preparation for the budgetary storms that lie ahead. It also would be likely to lead over time to some radical changes in the role and functions of the federal government.

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[8] This calculation assumes the levels reflected for these favored program areas in the House and Senate budget resolutions for as many years as such levels are indicated. Where such levels are not provided through 2009, the calculation takes the level for the last year indicated and adjusts it for inflation for the remaining years through 2009.

Appendix

Would these Proposals Boost National Saving?

An argument may be made that deposits into individual accounts enacted as part of Social Security reform legislation would add to national saving and consequently lead to a bigger economy, thereby yielding more revenue for the government and alleviating the long-term fiscal problems this paper discusses. Increased saving should aid economic growth, and a bigger economy would result in more tax revenue than a smaller one. But claims that this growth would make the budget numbers add up over the long term and address the fiscal problems discussed here would be unfounded.

- The CBO baseline assumes that all of the projected surpluses are saved, including the surpluses in *both* the Social Security and the non-Social Security budgets. By contrast, all current budget proposals — including both Democratic and Republican proposals — would expend part of the surplus (either through tax cuts or through programs). As a result, all of these proposals would result in *less saving* than is assumed under the CBO baseline.

- Since the Republican budget plans would lead to less saving than the CBO baseline assumes, one cannot say these plans will somehow generate saving that will keep them from exacerbating the long-term fiscal problems that the CBO baseline already reflects. The CBO baseline forecast shows deficits returning sometime after 2020 and climbing to record levels. The budget proposals before Congress would make these problems more severe. (The Republican plan — and the Clinton plan as well — would add to saving and growth only when compared to a different sort of baseline which assumes that all of the surpluses would be spent if no action is taken to prevent that. Under such an alternative baseline, the long-term budget forecast would be more dire. Doing modestly better than such a baseline still could lead eventually to fiscal crisis.)

Moreover, the Republican plan would result in significantly less saving than the Administration's plan. Under the Administration plan, about three-quarters of the unified budget surpluses projected over the next 15 years would be transferred to Social Security and Medicare and saved. (All of these transferred funds would be saved, since none of them would be needed to pay current Social Security and Medicare benefits.) In addition, most of the funds placed in the USA accounts the Administration has proposed would represent additions to national saving, since these funds generally could not be withdrawn and spent until an individual retired. Overall, more than 80 percent of the unified budget surplus would be saved under the Clinton plan, rather than used for current consumption. (Not all of the funds deposited in

USAs would represent new saving. Some individuals would feel they could place fewer resources in other saving vehicles since they would have USA accounts.)

Under the Republican plan, the bulk of the non-Social Security surplus would be used for tax cuts that boost current consumption, rather than for saving. Surplus funds that under the Clinton plan would be transferred to the Medicare trust fund or used for USA accounts, and hence largely saved, would instead be used for tax cuts and largely consumed. On the other hand, most of the funds placed in Social Security-related individual accounts under the Republican Social Security proposals now being developed would represent new saving, although as with USA accounts, not *all* of the funds placed in such accounts would constitute new saving. Some individuals would respond to the creation of the individual accounts by saving less elsewhere. Hence, under the Republican proposals, most of the Social Security surpluses (which constitute about 60 percent of total surpluses over the next 15 years) would be saved, but most of the non-Social Security surpluses would not be.

CENTER ON BUDGET AND POLICY PRIORITIES

March 19, 1999

THE LOCK-BOX PROPOSAL AND THE ECONOMY

By Robert Greenstein

The Republican leadership is proposing the establishment of a "Social Security lock-box" that has been described as preserving and protecting Social Security by ensuring that Social Security surpluses are saved and used to pay down the debt, rather than used for other purposes. Senator Spencer Abraham unveiled this legislation this week on behalf of the Senate leadership.

A separate Center on Budget and Policy Priorities analysis explains why this lock-box proposal would not actually require Social Security surpluses to be used to reduce the debt. That analysis, "The Republican Budget Proposals," shows that due to a major loophole in the proposal, it could result in little debt reduction and has, in fact, been designed to facilitate the passage of proposals to convert part of Social Security to individual accounts.

This analysis examines several other issues related to the Abraham lock-box proposal, including its likely effects in exacerbating future economic downturns and its potential to trigger a government default. The shortcomings of this proposal do not mean, however, that proposals to lock away surplus Social Security reserves are unwise, but rather that such proposals need to be designed in a fashion that avoids the pitfalls of the Abraham approach.

How the Lock-box Would Work

The proposal would establish steadily declining statutory limits on the debt held by the public. These limits would essentially equal the current Congressional Budget Office projections of what the debt levels would be in the next 10 years if the *non*-Social Security budget is balanced and all of the Social Security surpluses are used to pay down debt.

Except for automatic adjustments that would be made in these debt limits to reflect changes in the size of the Social Security surpluses as well as the effects of Social

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Security reform legislation,[1] these debt limits could be raised only by a three-fifths vote in the Senate and a majority in the House. This means that if the non-Social Security budget threatened to fall out of balance and consequently needed to borrow some funds, this borrowing would be prohibited unless a super-majority could be assembled in the Senate to pass legislation specifically allowing it.

Until now, it has taken a simple majority of Congress to raise the debt limit. On numerous occasions, it has been difficult to amass a simple majority for this purpose, even when the debt limit clearly had to be raised and there was no feasible alternative. Votes to raise the debt limit typically are surrounded by high-stakes political maneuvering. Securing a three-fifths vote in the Senate to raise the debt limit could prove exceedingly difficult.

The idea behind the legislation is that if the non-Social Security budget threatened to fall out of balance, Congress and the President would have to reach agreement on ways to reduce government expenditures or increase tax collections to keep the non-Social Security budget in balance. But it is possible that such an agreement could not be reached, and a super-majority in the Senate would not vote for legislation to raise the debt limit. It that occurred, the Secretary of the Treasury would have to default on financial obligations of the U.S. Government — an unprecedented step that could have substantial costs — or withhold government payments, including payments to beneficiaries of government programs, government contractors, and Medicare providers. The payments affected could include Social Security checks and benefits for poor children and families. The Secretary would have to take these actions even if the *unified* budget (i.e., the total budget, including Social Security) remained in surplus.

Why the Non-Social Security Budget Could Fall Out of Balance For Reasons Beyond Policymakers' Control

Congress and the President are likely to enact legislation this year that uses most or all of the projected non-Social Security surpluses for tax cuts and government programs. Not much, if any, of the projected non-Social Security surpluses is likely to remain. The Republican budget resolution proposes using most of the projected non-Social Security surpluses for tax cuts, and some tax cuts are likely to pass this year. The Administration and a number of Members of Congress of both parties have called for

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[1] The debt limits would be decreased or increased automatically to the extent that annual Social Security surpluses proved to be larger or smaller than the current CBO forecast assumes. The debts limits also would be adjusted automatically to reflect the impact of Social Security reform legislation on the debt held by the public. These adjustments are discussed in the Center analysis, "The Republican Budget Proposals."

using a portion of these surpluses to ease the current, tight caps on discretionary spending; some easing of these caps appears likely, especially in light of the bipartisan support for defense spending increases.

If Congress and the President pass legislation this year that is projected to result in balance or modest surpluses in the non-Social Security budget but the economy later weakens and grows more slowly than CBO has forecast, the non-Social Security budget will likely slide back into deficit. The resulting deficits could be substantial. CBO estimates that a downturn of the size of the recession of the early 1990s, which was not a severe recession as recessions go, would increase the budget deficit (or reduce surpluses) by approximately $85 billion a year after the recession hits bottom.

CBO cautions that its surplus forecasts could be off by even larger amounts if revenues grow more slowly than forecast. Analysts do not fully understand why revenues have grown more rapidly than projected in recent years, and they do not know the extent to which the factors that have caused this unexpected revenue growth are temporary or permanent. Revenue growth in future years could be significantly lower or higher than CBO currently projects. If it is significantly lower (and legislation using most of the non-Social Security surpluses currently projected has been enacted), deficits in the non-Social Security budget are likely to return.

A drop in the stock market also would result in lower-than-expected revenue collections, since less capital gains tax would be collected. That, too, could push the non-Social Security budget back into deficit.

CBO this year devoted a full chapter of its annual report on the budget and the economy to the uncertainty of its budget projections. CBO warned that "considerable uncertainty" surrounds its budget estimates "because the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict. Consequently, actual budget outcomes almost certainly will differ from the baseline projections..." [2] CBO reported that if its estimate of the surplus for 2004 proves to be off by the average amount that CBO projections made five years in advance have proven wrong over the past decade, the forecast for 2004 could be too high or too low by $300 billion.

Even if the budget forecast proved accurate and the budget was in balance for a fiscal year, the Treasury still could need to borrow additional amounts during certain months of the year and to exceed the debt limit temporarily. Expenditures and revenue collections do not precisely match each other on a month-to-month basis. The non-

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[2] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal years 2000-2009*, January 1999, p. 81.

Social Security budget can be in deficit for part of the year but in balance for the year as a whole.

The lock-box provision would not permit any such deficits, however, unless three-fifths of the Senate and a majority of the House voted to allow them. In the absence of such Congressional approval, the Treasury would be barred from borrowing any funds in excess of debt limits that had been set with the assumption that the non-Social Security budget would be in balance at all times throughout the next 10 years.

The Dangers to the Economy

In years when economic growth is sluggish, revenues rise more slowly while costs for programs like unemployment insurance increase. Forecasts that the budget will be in balance are overtaken by events, and deficits emerge. Under the lock-box proposal, such deficits would not be permitted.

Fiscal retrenchment in the form of program cuts or tax increases consequently would be required in periods of slow growth and recession. The slower the growth, the larger the expenditure cuts or tax increases required to keep the debt limits the lock-box legislation has established from being exceeded.

This is the reverse of how fiscal policy should function when the economy falters and recession threatens. The lock-box proposal carries a sizeable risk of making recessions more frequent and deeper, as a result.

The economic problems the nation faced in the 1930s were far more severe than anything likely to develop in the years ahead. Nevertheless, the policy mistakes made in that era are instructive. From 1930 to 1933, Congress repeatedly cut federal spending and raised taxes, trying to offset the decline in revenues that occurred after the crash of 1929. These spending cuts and tax increases removed purchasing power from the economy and helped make the downturn still deeper. They occurred at precisely the wrong time in the business cycle.

This is why proposals such as the lock-box measure are called "pro-cyclical" — they exacerbate the natural business cycle, making downturns more severe. This also is why most economists who favor strong debt-reduction measures oppose legislative requirements which mandate that the budget be balanced each year as the Republican lock-box proposal would do.

In testimony before the House Budget Committee in 1992, one of the nation's most respected economists, then-Congressional Budget Office director Robert Reischauer, made a number of these points. Reischauer was referring then to a

constitutional balanced budget requirement, but the issue is essentially the same as the one the lock-box proposal raises. "[I]f it worked," Reischauer warned, "[a balanced budget amendment] would undermine the stabilizing role of the federal government." He explained that the automatic stabilizing that occurs when the economy is weak "temporarily lowers revenues and increases spending on unemployment insurance and welfare programs. This automatic stabilizing occurs quickly and is self-limiting — it goes away as the economy revives — but it temporarily increases the deficit. It is an important factor that dampens the amplitude of our economic cycles." Under a balanced budget requirement, Reischauer observed, these stabilizers would no longer operate automatically and hence would be less effective.[3]

Proponents of the lock-box proposal respond that the proposal would allow the debt limits to be raised for a fiscal year if three-fifths of the Senate and a majority of the House voted to allow that. But this is not a sufficient response. It is unlikely a three-fifths majority would materialize until *after* the economy was already in a recession and considerable economic damage had been done. The Office of Management and Budget and the Congressional Budget Office have rarely, if ever, forecast a recession before one started. We usually do not know we are in a recession until the downturn is at least several months old.

As a result, the lock-box proposal would likely lead to the stiffest austerity measures being taken in years when the economy was weakening but not yet in recession. Such actions could tip a faltering economy into recession and make an ensuing recession deeper.

Adding to this problem, a three-fifths majority could be particularly difficult to garner if a recession were regional rather than national, as is usually the case at least at the start of economic downturns. It might not be possible to obtain a three-fifths majority until a recession had spread to a substantial majority of states.

Past recessions generally have started in some regions and taken time to spread; they also have hit some regions much harder than others. In the last recession, for example, New England and the mid-Atlantic states began experiencing declines in employment by the second quarter of 1989, a full year before employment turned down in most of the rest of the country. If rising unemployment insurance costs and falling revenues in several regions threatened to push the federal budget out of balance, would enough Members of Congress from states where economic problems were not yet evident be willing to raise the debt limit and allow the non-Social Security budget to run a deficit? If not, not only would fiscal retrenchment be required that could make

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[3] Statement of Robert D. Reischauer, Director, Congressional Budget Office, before the House Budget Committee, May 6, 1992.

the downturn deeper, but regions needing federal recession relief might find it was not forthcoming.

Economic downturns also tend to last longer in some regions than others. In the last recession, employment losses lasted two to four years in California and much of New England and the mid-Atlantic states, while a number of other states recouped their employment losses in a matter of months. This pattern was reversed in the recession of the early 1980s; that downturn was sharpest and lasted longest in the Midwest and South. The regional patterns that characterize economic downturns raise questions about the wisdom of enacting legislation that prohibits deficits in the non-Social Security budget and allows this structure to be relaxed only if three-fifths of the Senate so approves.

Increasing the Risk of Government Default

The proposal also is likely to make crises in which a government default threatens more frequent and to heighten the risk that such a default actually could occur.

As noted above, it now takes a simple majority of both houses of Congress to raise the debt limit. On a number of occasions, it has proved difficult to secure such a majority to raise the debt limit. Securing a *three-fifths* vote in the Senate to raise the debt limit, as the lock-box proposal would require, could prove excruciating.

As explained above, a non-Social Security budget balanced at the start of a year could easily slip out of balance during the year for a number of reasons beyond policymakers' control, such as slower-than-expected economic growth, smaller-than-expected revenue collections, or a natural disaster. If such a development occurred with part of the fiscal year gone, the budget cuts or tax increases required to avert a need to borrow, even on a temporary basis, might be unattainable. Enacting and implementing measures to produce budget savings would generally take some time; such savings would not begin appearing instantaneously upon enactment of the deficit-reduction measures. Yet only a limited number of months might remain in the fiscal year. Budget cuts or tax increases sufficiently deep to secure the necessary savings in a few months could be extremely difficult if not impossible to pass.

Suppose, for example, non-Social Security outlays turned out to be a modest one percent higher than CBO estimated at the start of the year, while revenues (other than Social Security payroll taxes) turned out one percent lower. A budget initially thought to be in balance would develop a deficit of close to $30 billion. If this potential deficit was recognized part way into a fiscal year, it could be difficult to address in that year. The highly controversial balanced budget plan embodied in the budget resolution that

the hard-charging 104th Congress passed in 1995 would have achieved less than $30 billion in savings (in today's dollars) in the first fiscal year it was in effect. Yet that budget would have had *a full 12 months* in which to realize those savings.

It may prove impossible in such circumstances to secure agreement by Congress and the President on budget cuts or tax increases large enough to restore balance to the non-Social Security budget, especially if such measures would slow an already-weakening economy. Yet the alternative — allowing a deficit in the non-Social Security budget and borrowing the funds to cover it — would require a three-fifths Senate vote. If a three-fifths majority could not be secured to raise the debt limit, a default crisis would loom.

The Consequences of a Default

CBO has warned that even a default lasting only a few days could have lasting consequences, because it could erode confidence in the binding nature of the financial obligations of the U.S. Government and raise government costs as a result. The national debt is financed at relatively low interest rates because those who purchase government securities are confident they will be repaid in full and on time. Similarly, federal defense and highway contracts are less costly than they would be if contractors lacked confidence of being paid in full and on time. If a default occurred, even if only for a brief period, confidence in the U.S. Government's ability to make payment in full and on time could be shaken. The interest rates the government must pay on securities that the Treasury issues could rise, as could the costs of government contracts. These increased costs could last for years. A default also could lead to a lowering of the U.S. Government's credit rating and to a lessening of our effectiveness internationally in prodding other countries to avoid defaults.

Giving Minority Factions Power to Disrupt the Economy

Finally, the requirement that the debt must shrink in line with pre-determined debt targets unless three-fifths of the Senate (and a majority of the House) agree to raise the debt limits would have another important consequence. It would confer upon minority factions in the Senate an unprecedented degree of leverage over national economic and fiscal policy.

Due to the supermajority requirement, minority factions could withhold support for an increase in the debt limit when a recession loomed, threatening to plunge the government and the economy into turmoil (and the Treasury into default) unless they were granted major policy concessions. Minorities willing to threaten turmoil and disruption to achieve their ends could gain unprecedented power.

One can, for example, envision a minority insisting on large tax cuts that do not expire when a recession ends as its price for agreeing to raise the debt limit during a downturn. The minority might use supply-side arguments and claim the permanent tax cuts would ignite long-term economic growth. Still-deeper cuts in basic programs could then be needed in subsequent years to offset the ongoing revenue losses resulting from the permanent tax reductions.

Conclusion

Measures to prevent inappropriate uses of Social Security surpluses can represent sound policy if carefully designed. Using debt limits enforced by supermajority voting requirements and backed up by threats of default, however, are an unwise way to achieve this goal.

Since 1990, the nation has used other mechanisms to enforce fiscal discipline — rules requiring that the costs of tax cuts and entitlement increases be offset, and rules imposing caps on discretionary spending. These mechanisms have been highly effective. They have operated without threatening budget cuts or tax increases when the economy weakened and without creating risks of government defaults. Mechanisms can be fashioned to enforce fiscal discipline and prevent inappropriate uses of Social Security surpluses, building on the successes of the past decade's budget enforcement mechanisms, without posing the unacceptable risks that the Senate leadership's legislation carries.

CENTER ON BUDGET AND POLICY PRIORITIES

March 17, 1999

REPUBLICAN TAX PLAN RISKS NEW ON-BUDGET DEFICITS AFTER 2009

by Iris J. Lav and Sam Elkin

The proposed House and Senate Republican budget resolutions include tax cuts designed to absorb most of the on-budget (non-Social Security) surplus for the next ten years. To follow the path of the anticipated surplus, the tax cuts start relatively small and grow substantially over time. The proposed resolutions include tax cuts costing $142 billion over the first five years, with the cost rising to $636 billion in the second five-year period. In the words of Ways and Means Committee Chairman Bill Archer, the tax cuts "....wedge out as the years go on."[1]

In fact, *by 2007 the annual cost of the proposed tax cuts exceeds the amount of the on-budget surplus the Congressional Budget Office estimates will be available.*[2] The additional tax reduction is "paid for" by further reductions in non-defense discretionary spending, beyond those the 1997 budget agreement already requires. By 2009, the Senate budget resolution would require non-defense discretionary programs as a whole to be cut 28 percent below the fiscal year 1999 base, adjusted for inflation. Under the House resolution, the cut would be 29 percent by 2009.[3]

Needless to say, it would be difficult actually to enact spending reductions that eliminate one-quarter to one-third of non-defense discretionary spending. Because some non-defense discretionary programs are deemed essential, and others such as education, highways, veteran's health, crime programs, and NIH research would be protected from cuts or slated for increases, the remaining non-defense discretionary programs would have to be cut even more deeply or eliminated.

Looking beyond 2009, the problem becomes still greater. Three factors suggest these tax cuts will become unaffordable after 2009 and would almost certainly bring back deficits in the non-Social Security budget.

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[1] Bureau of National Affairs, *Daily Tax Report*, March 12, 1999, p. GG-1.

[2] These figures are based on CBO's "capped baseline," which assumes discretionary spending increases with inflation after the current caps expire in 2002. This is the standard baseline that CBO and OMB use to estimate the extent to which the budget will be in deficit or surplus.

[3] The fiscal year 1999 levels for non-defense discretionary programs used here exclude emergency spending.

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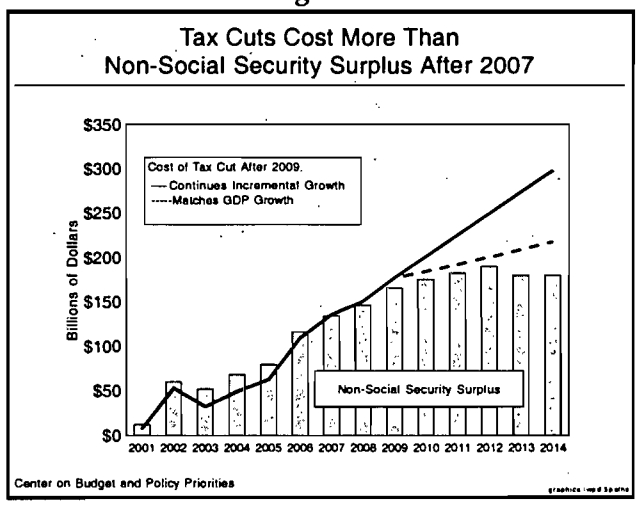
- CBO baseline projections indicate that the non-Social Security surplus stops growing and begins to shrink during the five years after 2009.[4] Once the surplus stops mounting and begins to contract, there will be a smaller non-Social Security surplus each year to support a tax cut.

Figure 1



- But the cost of the tax cut is likely to continue growing substantially after 2009. The size of the tax cut in the Senate resolution grows from $32 billion in 2003 to $177 billion in 2009, an annual average increase in cost of more than $24 billion a year. Between 2008 and 2009, the cost grows by $26.5 billion.[5] If this incremental growth were to continue in the years beyond 2009, the cost of the tax cut would rise from $636 billion in 2005-2009 to $1.25 *trillion* in the five years from 2010 to 2014.

  Even if growth in the tax cut could be held down to the rate of growth in GDP in years following 2009 — which likely would require reductions in tax relief at that time — the cost of the tax cut in the five years from 2010 to 2014 would exceed $1 trillion. (See Figure 1.)

- With the size of the non-Social Security surpluses beginning to decline and the cost of the tax cut continuing to grow, the only way to avoid a re-emergence of on-budget deficits would be to make cuts in programs on top of those that would made by 2009. Such cuts, which could entail eliminating a sizable share of what remained in non-defense discretionary spending, are not likely to be achievable. As a result, the tax cuts in the House and Senate budget resolutions would likely result in a return of deficits in the non-Social Security budget.

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[4] The CBO baseline goes through 2009. The CBO capped baseline was extended to 2014 for purposes of this analysis by applying the growth rates in the CBO long-term forecast. The projections show that annual surpluses in the non-Social Security budget begin to decline after 2012. Policy changes could shift by one or a few years the specific year in which these surpluses begin to shrink, but such shrinkage is virtually certain to occur some time shortly after the baby boom generation begins to retire.

[5] In the Senate budget resolution, the size of the tax cut grows by an average of $24.2 billion a year between 2003 and 2009, while in House version the average annual growth is $24.6 billion. In the House version, the cost grows from $30.7 billion in 2003 to $178 billion in 2009, and growth between 2008 and 2009 is $24.8 billion.