Could We Invest the Surplus?
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In last month's testimony before the Senate Budget Committee, Federal Reserve Board Chair Alan Greenspan justified his new-found support for tax cuts out of concern that looming surpluses could force the government to hold "significant amounts of private assets [which] would risk sub-optimal performance of our capital markets, diminished economic efficiency, and lower overall standards of living." Op-ed writers for the *Wall Street Journal* have seized upon this theme predicting that if tax cuts aren't instituted promptly the federal government's stock market portfolio could grow to $20 trillion dollars by 2020, greater than the current market capitalization of all equities in the U.S. today.

As political rhetoric, this line of argument is genius. It equates failure to enact a substantial tax cut with the socialization of the U.S. economy. But as a matter of economic reality is simply silly. There are many ways in which the federal government could prudently invest surplus funds. Moreover, if the proposition that the government cannot invest in private assets becomes axiomatic within the beltway, there would be profound and undesirable consequences for fiscal policy and the most troubling for the future solvency of the Social Security and other social insurance trust funds.

Admittedly, the size of the Congressional Budget Office's most recent surplus estimates are impressive. Over the next eleven years, the U.S. Treasury is projected to take in $5.6 trillion more than it spends. Much of that money could be used to pay off the federal debt. But, as Chairman Greenspan's remarks suggest, there is only $3.4 trillion of federal debt currently outstanding, and some of that debt – the CBO estimates some $818 billion – would still be outstanding after eleven years, mounting surpluses notwithstanding. So the government could end up accumulating nearly $3.2 trillion of "uncommitted funds" by the end of 2011, with most of this build-up coming in 2008 and beyond.

The future may be less kind to the economy than government economists are predicting – that's why Greenspan's Fed has cut the discount rate twice already this year – but accepting for purposes of argument the CBO's optimistic assumptions about economic growth in the coming decade, the question Chairman Greenspan has raised is whether the size of this projected surplus is so daunting that Congress should alter fiscal policy rather than running the risks associated with investing over $3 trillion dollars in the final years of this decade.

Let's start with the stock market. The chorus lining up behind Chairman Greenspan acts as if these projected surpluses would force the government to buy up the entire American stock market and then some to disperse its new found wealth. But this is bad math. Currently the U.S. equity market capitalization is roughly $19 trillion dollars. If the economy were truly to grow at the rate the CBO projects, the value of stock would also rise and, if one uses a 10 percent nominal rate of growth, the projected stock market capitalization at the end of eleven years would be $ 54.3 trillion. So, if the U.S. Treasury put all of its excess funds in common stocks, the government would be buying roughly six percent of the market – a substantial investment to be sure, but hardly the market-swamping slug that Chairman Greenspan intimated and his supporters have claimed. (By way of comparison, state and local retirement funds have for some time held about ten percent of the corporate equities in the United States without any noticeably untoward effects.)

Of course, *any* federal government investment in the stock market would raise political hackles in some circles. Even though the federal government already holds tens of billions of dollars of stocks in retirement accounts for government workers and even though there are proven mechanisms for constraining possibly negative effects of public investment in private corporations, some fear political entanglements if the Treasury's holdings were to grow larger. So perhaps it would be just as well if the government stayed out of stock market. But does that mean there is no place else to invest mounting surpluses?

Clearly, no. There's the private debt markets. According to Federal Reserve Board figures, there was $14.6 trillion of debt outstanding at the end of last year, not including debt owed to the federal government. That includes $6.3 trillion of business debt; $7.1 trillion of consumer debt; and $1.2 trillion of state and local government debt. Again assuming a robust economy over the next decade, it seems reasonable to assume that the volumes of debt outstanding will also increase substantially in the years ahead. The U.S. Treasury could put its *entire* projected windfall of $3.2 trillion in the debt markets and still likely hold less than ten percent of the overall debt market, without buying up one share of stock.. Or we could spread our investments across debt and equity markets and hold perhaps three percent of each.

But doesn't investment in debt markets create the same potential for government entanglement that equity investments pose? Well, as a legal matter, creditors typically are much less involved in managerial decision-making than shareholders, and bondholders are less involved than the average creditors. But, if one is truly concerned with debtor-creditor entanglements between the government and its citizens, we have a much more serious problem than investing potential surpluses a decade down the road. Each year American citizens and corporations incur more than $2 trillion worth of obligations to the federal government as a result of our taxation system. When one considers the entanglement this relationship entails, the potential problems posed by the government buying $3.2 trillion of bonds ten years hence pale by comparison.

Nor are potential governmental investments limited to U.S. financial assets. There is ample precedent for investments in real estate (remember the Louisiana Purchase and Seward's Folly). It is not entirely clear that it would be inappropriate for the government to add to its holdings of land in the West and earn income by leasing the lands out to ranchers and lumber companies, as much of the public lands are leased out today. Or there is debt of multi-national organizations like the IMF or World Bank or even foreign stocks and bonds. In short, there are many different ways in which the government might invest a surplus, should it choose to run one. Suggestions that the surplus would have to be deployed as a destabilizing blob in the U.S. stock market are wrong and misleading.

The problem with Chairman Greenspan's ruminations over the dilemma of mounting surpluses is that they have implications far beyond the Bush Administration's pending tax cut proposals. The logic of the position – that the government should not accumulate any private financial assets – could lead to many other undesirable policy decisions. It would, for example, preclude the government from contributing to improvements in the nation savings rate, beyond eliminating its own borrowing needs. This seems a needless and ultimately unwise constraint on congressional prerogatives.

An important case in point is the government's policy with respect to looming crises in Social Security and other social insurance programs. If ever there were an area in which it makes sense for the government to put aside a little extra money for a rainy day, this would seem to be it. But, if the government cannot hold private financial assets, we have a problem. The Social Security trust funds are currently projected to grow to $3.7 trillion by 2011. If you add in other comparable accounts – like Medicare – the total government holdings are expected to equal $5.9 trillion by 2011, almost twice as much as the CBO's project "uncommitted funds" from on-budget surpluses. Under the "lock-box" constraints widely accepted in Washington today, these trust fund reserves are not to be spent on other government programs. And, as Chairman Greenspan's testimony explains, the trust funds wouldn't be able to find enough government bonds to absorb these assets. So, what are the trust funds supposed to do? One obvious answer would be to invest their reserves in private financial assets. But if that investment strategy is politically out-of-bounds, then the only way out is wholesale privatization of the Social Security system. Can Chairman Greenspan have endorsed yet another Bush Administration initiative?