

**Statement of
Robert D. Reischauer
Director
Congressional Budget Office**

**before the
Legislation and National Security Subcommittee
Committee on Government Operations
U.S. House of Representatives**

October 12, 1989

NOTICE

**This statement is not available
for public release until it is
delivered at 10:00 a.m. (EDT),
Thursday, October 12, 1989.**

Mr. Chairman, I am pleased to appear before the Subcommittee this morning to discuss the budgetary treatment of trust funds, and of Social Security in particular. Because this topic is closely bound up with the issue of overall budget targets and appropriate fiscal policies, I will address it in those terms.

The main point of my remarks is that the most important implication of deficit targets and of the budgetary treatment of Social Security is their effect on national saving. The budget deficit reduces national saving, thereby affecting the future size of the economy and the government's ability to provide Social Security benefits for future retirees. Trust fund balances contribute to government saving or dissaving in the same way as the non-trust fund accounts and, therefore, should continue to be included in any deficit target.

NATIONAL SAVING IS TOO LOW

The American rate of saving is low by both historical and international standards. This low saving is partly due to our large budget deficit, and it implies that future living standards will grow more slowly than they otherwise would.

Since 1980, net national saving has averaged only 3.2 percent of net national product (gross national product less capital depreciation) compared with 8.1 percent in the 1950-1979 period. The decline in the American saving rate stems about equally from declines in the private saving rate and from the increase in the government deficit. The budget deficit reduces national saving because it absorbs a significant part of household and business saving and uses it to finance government consumption. Only the part of nonfederal saving that is left can be counted as national saving.

The federal deficit currently represents more than 3 percent of net national product (NNP). The Congressional Budget Office's (CBO's) most recent budget estimates indicate that the federal government will continue to run large deficits unless significant changes are made in budget policy. Under current policies, the deficit will average 2.5 percent of NNP in 1990 through 1994 (see Table 1).

LOWER SAVING RATES MEAN SLOWER GROWTH OF LIVING STANDARDS

Low saving translates into slow growth in living standards. Limited saving restricts the pool of capital available for productive private investment. This shrinkage has occurred recently. Net investment

averaged 6.8 percent of NNP in the 1950-1979 period but only 4.7 percent during the 1980s. Less investment causes less growth in the amount of capital per worker and ultimately slower growth in workers' productivity and wages.

The most direct way to increase saving and improve the outlook for living standards is to reduce the budget deficit. CBO's analysis, which was reported in our January 1989 annual report, suggests that reduc-

TABLE 1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars												
Total Deficit	-161	-141	-144	-141	-143	-128	-111	-104	-92	-77	-51	-32
Off-Budget (Social Security) Surplus	54	65	75	86	99	113	127	144	163	185	209	236
On-Budget Deficit	-215	-206	-219	-227	-242	-241	-238	-248	-255	-262	-260	-268
Trust Fund Surplus	122	135	143	150	161	175	189	209	230	251	275	300
Federal Fund Deficit	-283	-276	-287	-290	-303	-303	-300	-313	-322	-329	-326	-332
As a Percentage of Gross National Product												
Total Deficit	3.1	2.6	2.5	2.3	2.1	1.8	1.5	1.3	1.1	0.8	0.5	.0.3
As a Percentage of Net National Product												
Total Deficit	3.5	2.9	2.8	2.5	2.4	2.0	1.6	1.4	1.2	0.9	0.6	0.3

SOURCE: Congressional Budget Office.

NOTE: CBO's baseline budget projections assume that laws affecting revenues and entitlement spending will continue without change. For defense and nondefense discretionary spending, the projections for 1990 through 2000 are based on 1989 appropriations, adjusted only to keep pace with inflation. This latter assumption, however, becomes increasingly unrealistic the further it is extended. By the year 2000, for example, defense and nondefense discretionary spending would represent only 4.3 percent and 2.9 percent of GNP, respectively -- far below any recent levels.

ing the federal budget deficit would raise living standards over the longer run, even though the spending cuts or increased taxes needed to accomplish this would reduce growth in consumption initially. The higher saving would raise capital accumulation, and eventually output and consumption would also increase.

HOW MUCH SAVING IS ENOUGH?

The existing Balanced Budget Act targets embody the strong consensus that America now saves too little. Eliminating the federal deficit could raise the total saving rate substantially from its recent level of about 3 percent of NNP. How far should fiscal policy go in raising the national saving rate? Economic analysis alone cannot answer this question. Some analysts believe that, because much federal spending has long-term benefits, limited deficits are acceptable. To others, a balanced budget is good enough. Still others propose that we go further and aim for an overall budget surplus after 1993. With the current targets proving hard enough to reach, these more ambitious targets would be truly daunting, as the long-run projections in Table 1 indicate.

Reducing the deficit, however, is not our only objective. Instead, the government may want to leave more resources in private hands for

taxpayers to spend or save as they wish. Alternatively, we may wish to devote additional resources to solving pressing public problems, such as combating drugs, improving education and health care, cleaning up the environment, or expanding research and development. Even if economic growth is the primary objective, the combination of increased government surpluses and more private investment is not the only effective policy. Increased government investment in physical, human, and intellectual capital can also increase economic growth, although it would not add to national saving as it is currently measured.

TRUST FUNDS SHOULD BE INCLUDED IN DEFICIT TARGETS

From the perspective of future Social Security taxpayers and beneficiaries, the most important issue is the extent to which budget deficits reduce national saving. Increased national saving will raise the living standards of both workers and retirees when the baby-boom generation retires in the next century. A smaller portion of the population will be working then, and what those workers produce will have to be shared--through Social Security and other means--with the relatively large number of retired people. Taking steps to increase the size of the economy in the next century would not substantially reduce

the share of gross national product (GNP) devoted to Social Security, but it would allow both workers and retirees to have higher standards of living than would otherwise prevail.

The most important measure of the impact of the federal budget on national saving is the total deficit, not any part of it. The total government deficit, including Social Security and other trust funds, determines the government's borrowing needs and the amount of saving that it diverts from uses that promote growth in living standards. This perspective explains why most analysts believe that the current Balanced Budget Act approach, which includes Social Security in the totals for determining whether the deficit targets are met, is economically the correct one.

This is not to say that a balanced total budget, including Social Security, is the most appropriate deficit target. As indicated earlier, there are arguments for running overall deficits or surpluses. Some observers advocate isolating the Social Security surpluses in order to help achieve a desired overall surplus; they argue that this would make the deficit in the non-Social Security accounts more visible, and that it would be easier to achieve and maintain a surplus in Social Security than elsewhere in the budget. In terms of national saving, however, balancing the non-Social Security budget is not necessarily the right target. The existing schedule of reserve buildup in Social

Security did not reflect a deliberate decision to abandon pay-as-you-go financing, nor did it represent a well-thought-out national saving objective.

SEPARATE BUDGETARY TREATMENT POSES PRACTICAL PROBLEMS

Targeting only one part of the budget is also likely to lead to practical problems. If Social Security were removed from the targets, what about Hospital Insurance, which is scheduled to be taken off-budget in 1993? What about Supplementary Medical Insurance, federal employee retirement, the airport and highway trust funds, deposit insurance, or capital spending? If one program is given special treatment, it is very hard to keep other programs from squeezing through the door.

Taking Social Security out of the deficit targets may even backfire. That is, it may undermine the very surpluses that it would be intended to preserve. It certainly would be harder to fend off proposals to raise benefits or cut payroll taxes if the discipline of deficit reduction were not present. For example, the calls for eliminating the so-called notch by increasing benefits might have proved irresistible if Social Security had been excluded from the deficit calculations. Alternatively, if Social Security were not subject to the discipline of deficit targets,

some analysts might be tempted to expand the number of programs supported by the trust funds as a means of freeing up resources in the budget for additional spending. For example, if funding for Supplemental Security Income (SSI) were shifted to Social Security, the general fund resources that are currently devoted to SSI would be available for additional spending, without running afoul of deficit targets that applied only to the non-Social Security budget.

PROTECTING SOCIAL SECURITY IS NOT THE ISSUE

A common argument for balancing the non-Social Security budget and for building up reserves in Social Security is that we need a large Social Security trust fund to assure the payment of benefits when the baby boomers retire. This argument is largely based on a misconception. Under current policies, the share of our economy's resources devoted to the aged must increase substantially in the next century as a consequence of the baby boom of 1946 to 1964 and the subsequent birth dearth. Building up Social Security reserves cannot avoid the stresses that this reallocation of resources will produce.

Under current policy, as the Social Security trust funds grow, their reserves are invested in U.S. Treasury securities. When the baby

boomers begin to retire, Social Security will have to redeem its holdings of federal securities in order to pay the promised retirement benefits. To do this, the Treasury would have to borrow from the public--though it would still need to limit borrowing to promote national saving even then--or the government would have to cut spending or raise taxes elsewhere in the budget. Alternatively, returning Social Security to a pay-as-you-go basis--and accumulating no surpluses--would not make this tough fiscal problem any easier or more difficult. Tax increases, spending cuts, and borrowing would still be the only sources of funds to pay for the growth of benefits. Thus the status of the Social Security trust fund, as such, is not critical to the issue. The only potential difference between partial-reserve and pay-as-you-go financing is the mix of payroll and income taxes used to finance the baby boomers' retirement. There is no getting around the fact that the retirement of the baby-boom generation will have to be provided for out of the economic resources available at that time.

CHANGING TRUST FUND INVESTMENT POLICY IS NOT THE ANSWER

Removing Social Security from the deficit calculation is commonly linked with the suggestion that the trust fund balances be invested in private securities rather than Treasury bonds. Many future

beneficiaries might well feel more secure if the trust fund's reserves were invested in assets like these. Economically, however, changing Social Security's investment policies would make little difference: it would not make it easier for the economy to support both workers and retirees during the next century, and it would pose practical problems.

Increasing the future productivity of the economy is the only way to make currently scheduled Social Security benefits easier to bear. Having the Social Security trust funds acquire private-sector assets is unlikely to increase growth in productivity. Unless the total federal deficit were reduced at the same time, such a policy would merely redistribute the ownership of assets in the economy. With one hand, the government would supply additional funds to capital markets, as the Social Security funds acquired corporate bonds or stocks. With the other hand, however, the government would have to take back the same amount of funds, because the Treasury would have to borrow more from private lenders to make up for the lost financing from the trust funds. With the exception of bankers and underwriters, no one's income, consumption, or saving would be materially affected.

Purchasing stocks or corporate bonds would also increase the federal government's involvement in allocating private resources. It should be a matter of serious concern that the Congress would delegate to the Social Security trustees the power to choose the companies in

which to invest and the power to exercise influence over those companies as owners or creditors.

Investing Social Security's reserves in government capital projects, as has also been suggested, poses similar problems. Any increase in productivity growth would be at least partially offset because the federal government would have to borrow more from other sources to make up for the loss of funds from Social Security. If Social Security trust funds were used to build a highway or a school, for example, and if no other changes were made in government policies, the total government deficit would rise, and the additional government capital would increase our borrowing from abroad and reduce domestic investment. Unless the additional government capital were financed through higher payroll taxes or lower Social Security benefits, which no one has proposed, there seems to be little reason to finance it through the Social Security trust funds.

THE DEFICIT IS THE PROBLEM

By now you have heard many times that the problem is not the process; the problem is the problem. This is not to say that some changes in the budget process or in budgetary accounting might not make a small

contribution to reducing the deficit. But large budget deficits are not primarily the result of defects in the budget process. Rather, the process does not function well because profound political differences exist over how to reduce the deficit.

What, then, can be said about modifying the Balanced Budget Act targets or the budget process in general? The desirability of enacting multiyear deficit targets depends in large part on how effective one thinks such targets are. Our recent experience with the Balanced Budget Act targets does not provide a clear answer. Although deficit reduction has been proceeding at what seems like a glacial pace, many observers contend that progress would have been nonexistent without the Balanced Budget Act targets. Nevertheless, even without Gramm-Rudman-Hollings, the annual budget resolutions would probably have provided for declining deficits. Would year-by-year targets have been more or less stringent than those actually adopted, and would they have been adhered to more or less faithfully? My best guess is that the budget resolution targets would have been less tough, and that there would still have been slippage in implementing them.

Other effects of the Balanced Budget Act targets are clearer. A particularly damaging one is budgetary myopia--the exclusive focus on next year's deficit with little heed to long-run consequences. Although looking too far into the future poses its own problems, total

preoccupation with the here-and-now has two major flaws. First, it turns attention away from the real reason for fiscal responsibility--namely, to raise America's long-run saving rate--and makes deficit reduction an end in itself. Good public policy can never be made when symbols subvert substance in this way. Second, myopia has encouraged budgetary chicanery, such as shifted paydays, off-budget financing, and lease-purchase arrangements.

Finally, let me turn to the criteria that should be used if the Congress decides to amend the current deficit targets. Substantively, the targets should be set with the goal of curing a chronic saving shortage and bringing the national saving rate to a desired level. The bulk of my testimony has dealt with this issue. Procedurally, the targets should be designed to discourage excessive focus on the budget-year deficit. Along this line, biennial budgets, enforceable multiyear budget resolutions and reconciliation, and further limits on accounting gimmicks have some appeal. The experience of the last few years, however, makes it clear that every attempt at budget process reform has unintended consequences. Each of the possible changes I have mentioned therefore creates new risks and should be approached with caution.

Whatever reforms are adopted this year, the process is likely to be reviewed and revised again within a few years. Thus, the crucial

question before the Congress is not what deficit targets or budget procedures are needed after 1993. Rather, attention should focus on any changes that might help the Congress meet the 1990 and 1991 targets through real and long-lasting deficit-reduction policies.