Statement of
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before the
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NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EDT), Tuesday, September 19, 1989.

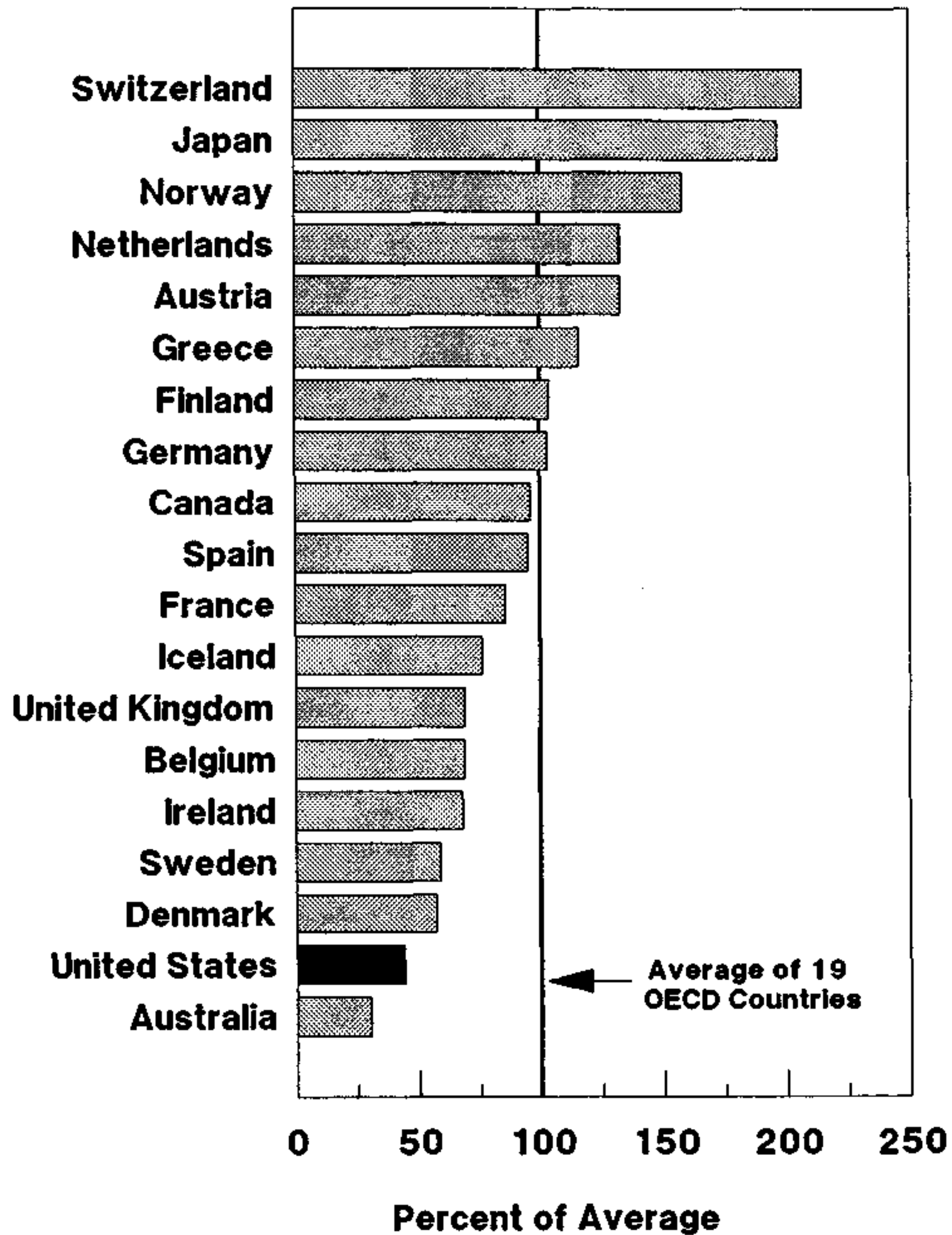
Mr. Chairman, I am pleased to appear before the Committee this morning to discuss long-run targets for the federal deficit. The main point of my remarks is that setting a fiscal policy target should be viewed as selecting a rate of national saving. Choosing a saving rate, in turn, is a question that economic analysis can inform but cannot answer. The answer hinges on judgments concerning such issues as the relative well-being of current and future citizens and the relative payoffs from various types of public and private spending.

NATIONAL SAVING IS TOO LOW

The American rate of saving is low both by historical and international standards. Since 1980, net national saving has averaged only 3.4 percent of net national product (gross national product less capital depreciation) compared with 8.2 percent in the 1950-1979 period.

Americans also save far less than residents of other industrialized countries. During the 1980s, the United States saving rate has been only 60 percent of the average for members of the Organisation for Economic Cooperation and Development (OECD). The United States ranks 18th out of 19 OECD countries (see Figure 1). Since the only lower-ranked country--Australia--has recently moved its government

FIGURE 1. NET NATIONAL SAVING, 1980-1986



SOURCE: Congressional Budget Office calculations based on data from the Organisation for Economic Cooperation and Development.

budget into surplus, however, the United States might now be dead last in saving.

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. Private saving by households and businesses averaged 8.7 percent of net national product (NNP) during the 1950-1979 period but only 6.3 percent during the 1980s. Government dissaving--the deficits of federal, state, and local governments--rose from 0.5 percent of NNP in 1950-1979 to 2.9 percent in the 1980s. This increase was attributable entirely to the rise in the federal budget deficit, since states and localities ran larger surpluses (primarily in their pension funds) in the 1980s than in the earlier period.

Currently, the federal deficit represents more than 3 percent of NNP. 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). Even if all of the deficit reduction measures contemplated in the fiscal year 1990 budget resolution were adopted, federal government dissaving would average 2.2 percent of NNP over the next five years.

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 unrealisitic 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.

LOW SAVING MEANS SLOW 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 7.8 percent of NNP in the 1950-1979 period but only 5.2 percent during the 1980s. Less investment causes less growth in the amount of capital per worker and slower growth in workers' productivity and wages.

A net inflow of foreign capital can substitute for domestic saving. During the 1980s, foreign investment in the United States exceeded American investment abroad by 1.8 percent of NNP. Because of this net capital inflow, net domestic investment dropped by only 2.6 percent of NNP from the 1950-1979 average rather than the 4.8 percentage-point fall that would have been required had domestic investment been limited by national saving.

The substitution of foreign capital for U.S. saving, while maintaining the growth of capital per worker, still depresses the growth of living standards. As the nation's indebtedness grows, it must devote an increasing share of its production to paying interest and dividends to foreign creditors, leaving less to be divided among its citizens. The figures for U.S. international transactions in the second

quarter of 1989, which were released on September 12, give a hint of what lies ahead. For the first time since 1958, the United States posted a deficit in trade in services, a category that includes financial flows. This imbalance can only worsen as the United States piles up more debt to foreigners.

The low rates of American saving and investment are particularly disturbing because current demographic projections imply that American living standards will improve less rapidly during the first half of the twenty-first century than during the second half of the twentieth century. In large part, this slower growth will be caused by the retirement of the post-World War II baby-boom generation. A smaller part of the population will be working, and what they produce will have to be shared with the increasing part of the population who will be retired. As a result, consumption of goods and services per person, which has been growing at about 1.9 percent a year since 1950, may increase by only 1.3 percent a year after 2000. Moreover, if saving rates and growth of productivity were to remain below historical averages, as they have recently, consumption per person would grow even more slowly.

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

reducing the federal budget deficit would raise consumption over the longer run, even though the spending cuts or increased taxes needed to accomplish this would reduce consumption initially. The higher saving would raise capital accumulation, and eventually output and consumption would also increase. But there is no way to estimate with precision how long it would take before consumption caught up to where it would have been without deficit reduction, or how much consumption per capita would increase in the long run. If the deficit were reduced by 2 percent of GNP, between five and ten years would be required for per capita consumption to be as high as it would otherwise have been. By the year 2040, per capita consumption could range from 2 percent to 14 percent higher than it would have been without the reduction in the deficit.

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 would raise the total saving rate from its recent level of 3½ percent of NNP to about 6½ percent of NNP. Is a 6½ percent saving rate high enough? Is it an appropriate target for fiscal policy? Economic analysis alone cannot answer these questions.

A 6½ percent saving rate would still be below the postwar average, but circumstances have changed. In particular, the working-age population is now growing more slowly, and less growth in the overall capital stock is needed to equip the smaller group of new entrants into the labor force. A minimal target for national saving is the rate that would be sufficient to maintain productivity growth at its current pace of 1 percent a year without relying on foreign saving. This pace would require saving 5 percent to 5½ percent of NNP. Eliminating the federal budget deficit would meet and exceed this level. It would still not be enough, however, to maintain the growth of per capita consumption at postwar rates in the face of slower labor force growth when the baby boom retires.

A 6½ percent saving rate would also be well below the average for other industrialized countries, but the United States has a record of low saving throughout the postwar period. Even during the 1960s and 1970s, the United States ranked last in net national saving and in the bottom third with respect to net private saving. Balancing the federal budget would lift America out of the cellar of the saving league, but it would not get us into the first division.

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. For example, Charles Schultze of the Brookings Institution suggests that the government should aim for a surplus of 1 percent of national income, which is equal to about 0.8 percent of GNP. Others propose that the government run surpluses equal to those now scheduled for Social Security, which will average 2 percent of GNP in the late 1990s, or for all trust funds. 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.

At some point, of course, the benefits of additional saving will no longer be worth the additional cost. The issue of setting deficit targets, as Herbert Stein has emphasized, therefore boils down to deciding how to allocate our national output among competing uses. There are no right or wrong answers. The choices, however, can be knowledgeable or ill-informed.

Instead of saving more, the federal government might get by with lower revenues, which would leave more take-home pay for taxpayers to spend or save as they wish. Alternatively, the resources could be devoted to 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.

FOCUS ON THE NEXT FEW YEARS

While an analysis of national saving cannot reveal the right deficit target to choose, it does suggest some specific conclusions.

First, any deficit targets chosen today for five or ten years from now may not seem reasonable when the time comes. Because the primary purpose of reducing the deficit is to increase national saving, the appropriate amount of government saving will depend on how much the private sector saves. If the private saving rate rebounds substantially, as a few analysts predict, the need for more government saving will be correspondingly lessened. The appropriate government deficit will also depend on the state of the overall economy and on the competing demands for government funds. To the extent that these items are unpredictable, it is impossible to choose today an appropriate deficit target for the year 1995 or 2000.

Second, extending the horizon for targeting deficits would be pernicious if it provided a distraction from more immediate goals. The existing targets for 1990 and 1991 can and should be achieved. Making the long-run aim more ambitious is not a substitute for meeting our short-term objectives.

LOOK AT THE TOTAL BUDGET

Lastly, any deficit target should apply to the total budget. The most important measure of the economic impact of the federal budget 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 its impact on credit markets and the economy. Therefore, the current Balanced Budget Act approach, which includes Social Security in the totals for determining if the deficit targets are met, is economically the correct one.

This is not to say that the appropriate deficit target is necessarily a balanced total budget, including Social Security. As indicated earlier, there are arguments for running overall deficits or surpluses. In terms of national saving, however, balancing the non-Social Security budget

is almost certainly not 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.

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? The Senate debate over the 1989 budget resolution taught us a clear lesson: 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 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

The only reason to advocate isolating the Social Security surpluses would be the judgment that a desired overall surplus would be easier to achieve and maintain in Social Security than elsewhere in the budget. A more common argument for balancing the non-Social Security budget and for building up reserves in Social Security, however, 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 sustantially 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.

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 holding of federal securities in order to pay the promised retirement benefits. To do this, the Treasury would have to borrow from the public, or the government would have to cut spending or raise taxes elsewhere in the budget. Returning Social Security to a pay-as-you-go basis 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. 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 boom's retirement. There is no getting around the fact that the retirement income of the baby-boom generation will have to be provided out of the economic resources available at that time.

Balancing future Social Security commitments against the resources available to meet them can be made easier in only two ways. One approach--scaling back future benefits--would directly reduce the growth of Social Security costs in relation to GNP. The second alternative--taking steps to increase the size of the economy in the next century--will not substantially reduce the share of GNP devoted to Social Security, but it would allow both workers and retirees to have higher standards of living than would otherwise prevail.

THE PROBLEM IS STILL THE PROBLEM

My predecessor Rudy Penner often remarked, "The process is not the problem; the problem is the problem." This is not to say that some changes in the budget process 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 well one thinks targets work. How to evaluate the recent experience with the Balanced Budget Act targets is by no means clear. 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.