

Testimony of Governor Edward M. Gramlich

The budget surplus and social security

Before the Committee on Finance, U.S. Senate

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Governor Gramlich presented identical testimony before the Committee on Ways and Means, U.S. House of Representatives, February 23, 1999

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to discuss Social Security reform. I speak for myself, as past chair of the 1994-1996 Quadrennial Advisory Council on Social Security, and not in my current status as a member of the Federal Reserve Board.

As you are all well aware, the U.S. population is aging. Today there are 3.4 workers per retiree; by 2030 it is projected that there will only be two. This fundamental change in the demographics of our population poses a large challenge: how can we provide adequate health and retirement benefits to our retired population, without imposing undue burdens on tomorrow's workers?

Clearly, the answer to this question is that we must act now to increase the total amount of resources to be available in the future. By increasing the size of our economy, we can devote a greater share of output to the retired population, without reducing the consumption of the working population. The only way to achieve this critical objective is for us to build up the stock of productive capital by increasing our rate of national saving. Indeed, in the current expansion, investment has expanded at a rapid clip, without inducing a rise in interest rates. This investment boom, and the accompanying step-up in the growth of the capital stock, is partly attributable to an increased rate of national saving. Between 1992 and 1998, national saving increased from 3.7 percent to 7.5 percent of net national product. While private and state and local government saving actually dipped during this period, this decline was more than offset by increased saving by the federal government through deficit reduction.

The stellar performance of the economy over recent years provides the nation a unique opportunity to begin to tackle its long-run problems. In particular, the large budget surpluses that are projected over the next 15 years or so, if they are permitted to materialize, will significantly improve our fiscal and economic position as the baby boom starts to retire. From the government's perspective, using those surpluses to pay down the federal debt will reduce future interest payments and free up future tax revenue; from the macroeconomic perspective, the increase in national saving represented by the increase in government saving will lead to a larger capital stock, higher productivity, and an improved standard of living.

From this standpoint, the broad objective of the Clinton Administration's budget--that is, to preserve most of the projected surpluses--seems to me both responsible and appropriate. The Administration would devote about \$1.4 trillion of the projected \$4.9 trillion of current law surpluses over the next 15 years to new spending, and use the remainder to pay down our national debt. According to the Administration's calculations, the ratio of debt held by the

public to GDP would fall from its current 44 percent to 7 percent by 2014. If such an outcome were to materialize, it would represent a dramatic improvement in the fiscal position of the nation.

Under current law, the Social Security revenues exceed outlays, creating surpluses that are credited to the Social Security trust fund. Without any legislative changes, the Social Security trust fund will continue to accumulate funds, reaching a peak in 2020 of \$3.8 trillion, or almost 16 percent of GDP. These surpluses both reduce the national debt **and** improve the long run fiscal condition of Social Security. This claim does not stem from any accounting gimmickry: By reducing future interest payments, these surpluses do indeed free up future revenues.

In addition to this accumulation already scheduled under current law, the Administration is also proposing to transfer an additional \$2.8 trillion of general revenues to the Social Security trust fund. While the Administration's rationale for these transfers is to ensure that the surpluses actually materialize, the transfer of general revenues represents a major shift from past practice, under which Social Security has been financed almost entirely from dedicated payroll taxes.

During the deliberations of the 1994-1996 Quadrennial Advisory Council on Social Security, we considered whether general revenues should be used to help shore up the Social Security program. This idea was unanimously rejected, for a number of reasons. First, using general revenues to fund Social Security puts the Social Security system in competition with other spending programs during the budget cycle. But Social Security is a long-range program--people pay dedicated taxes today toward benefits that may not be received for 30 or 40 years--and many feel that it should not be part of an annual budgetary allocation process.

Perhaps more importantly, using general revenues to fund Social Security undermines the fiscal discipline imposed by the need to ensure that income earmarked for Social Security is sufficient to meet the entire cost of the program, both in the short run and long run. Without a long-range budget constraint on Social Security, it will be much more difficult to limit future benefit growth. And, notwithstanding the large surpluses being projected, some reductions in benefits are almost certain to be necessary as the U.S. population ages.

It is important to remember that the aging of the population will bring pressures to programs other than Social Security. The trustees of the Medicare trust fund project that Medicare expenditures as a share of GDP will more than double--from 2.7 percent today, to over 5.8 percent in 2030, and Medicaid spending on long-term care likely will face similar increases. Because under the current budget system, Medicare Part B and Medicaid are financed with general revenues, there is much less pressure to take measures now to improve their long-run financing. But these programs too will put significant demands on government resources in the future. If we use the projected surpluses as a rationale for not making hard choices in Social Security, finding the resources to provide Medicare and Medicaid to our aging population will prove that much harder.

Thus, there are serious drawbacks to relaxing Social Security's long run budget constraint through general revenue transfers. I would prefer Social Security reforms that maintain the link between dedicated taxes and benefits, and maintain the value of long-range actuarial analysis. This discipline is essential if we are to limit the impending explosion of entitlement spending. The President's budget proposal, by preserving future surpluses and paying down our national debt, makes an important contribution to raising national saving. But to me the

proposal looks even better without the general revenue transfer.

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