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Testimony by

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Mr Chairman, I am pleased to be here today to discuss the government's role in providing retirement security to present and future generations--an issue that has moved to the forefront of the policy debate. Senator Moynihan has introduced legislation to cut payroll taxes and return social security to a pay-as-you-go basis, and others would like to move its finances fully off-budget.

In large part, such proposals arise out of frustration with the slow pace of deficit reduction, and they have helped to dramatize the seriousness of the current budget situation. But I am concerned that they will ultimately be counterproductive and hamper the efforts needed to meet our longer-term fiscal responsibilities And, as I hope to make clear, they will increase the difficulty of providing for the needs of an aging population in a way that is equitable across generations. I shall address in particular how the social security system can contribute to those objectives; this issue was a main focus of the National Commission on Social Security Reform in the early 1980s. I shall also touch on the relationship of social security to the rest of the budget and its role in the setting of overall budget goals.

I have testified often before committees of the Congress about the corrosive effects that sustained large budget deficits have on the economy and about the way our economic prospects in coming years will hinge on our ability to increase national saving and investment One factor that argues for running sizable budget surpluses by later this decade is the need to set aside resources to meet the retirement needs of today's working population Although the share of the total population that is in the labor force has risen steadily over the past

few decades, that percentage will shrink considerably after the turn of the century as members of the so-called "baby boom" generation begin to retire Barring a sharp upturn in the birth rate, a large influx of immigrants, or a significant increase in the age of retirement, growth of the labor force will slow appreciably.

The demographics are compelling In 1960, there were twenty beneficiaries for every one hundred workers contributing to social security; currently there are thirty. The Social Security Administration--under intermediate economic and demographic assumptions --expects that number to approach fifty by about the year 2025 and to remain at that level at least through the middle of the 21st century.

Assuming their living standards keep pace with those of the working population, the elderly will of necessity consume a growing proportion of total output in the future They will finance their consumption out of private and public pensions and by drawing down their own assets Nonetheless, the goods and services they buy can only come from the output of then-active workers. The allocation of production to meet the needs of retirees necessarily will cut into what is available for consumption by the rest of the population and for investment in new equipment and structures

We can do little to change the demographic forces We can, however, take actions now that will help to lift the size of future output above that implied by the current pace of capital formation and the trend in productivity Such actions will improve the likelihood that future workers can maintain their living standards while satisfying the retirement expectations of current workers Your decisions will

also influence how much of the burden of its retirement the baby boom cohort will shoulder for itself and how much will fall on its children Indeed, this is one of the few instances in which policymakers have had the luxury of being able to foresee a problem that a thoughtful policy response might ameliorate Thus far, I believe, the plan for social security, given the conflicting political pressures, has been reasonable.

One element in the strategy is the accumulation of sizable balances in the social security trust funds over the next few decades. As you know, before the Social Security Amendments of 1977, the system operated, in effect, on a pay-as-you-go basis The 1977 Amendments set in motion an accumulation of trust fund assets that can be drawn down as required to meet the retirement needs of today's workers This shift toward a funded system was given careful further consideration by the National Commission on Social Security Reform in the early 1980s

The deliberations of the commission identified several complex issues They included difficult questions of equity within and across generations and assessments of the effects social security has on incentives to work and save. We recognized, too, the political riskiness of accumulating large surpluses. On the whole, however, we concluded that each cohort of workers and their employers should make contributions into a fund that, with interest, at least approached the actuarial value of the benefits the workers will eventually receive Notably, this requirement forces today's workers--including the baby boomers--to pay more in payroll taxes than is needed to cover the benefits of the relatively small group of current beneficiaries, so that

sizable surpluses build up in the trust funds. In essence, the commission reaffirmed the intent of the 1977 Amendments; our recommendations were largely accepted by the Congress and hence shaped the legislation of 1983 The current structure of social security may not be appropriate in all circumstances But, at present, it is still the best option.

One reason to build surpluses in the trust funds is to set aside saving, and thus to divert part of the nation's current production away from consumption--both private and public Assuming, of course, that the surpluses are not offset by reductions in the saving of households and businesses or by larger dissaving, i.e. deficits, elsewhere in the federal budget, they should boost investment and thus foster the growth of the nation's capital stock And with more capital per worker than would otherwise be in place, productive capacity will be greater, and we will be better able to fulfill our promises to the retirees, while maintaining the standard of living of future workers

The relationships among saving, the aggregate capital stock, and labor productivity are complex and difficult to pin down quantitatively, in part because productivity depends not only on the amount of physical capital but on factors such as the education and skill level of the work force and the rate of technological progress Nonetheless, I have little doubt that a larger, more modern capital stock will improve labor productivity and hence overall real income levels in coming years

Building surpluses in the trust funds also contributes to fairness across generations Given the demographics, the generation

after the baby boomers will have to shoulder a fairly heavy burden to meet the retirement claims of their parents. This burden can be ameliorated only if current workers save enough during their working years to fund, in effect, their own retirement. Saving today will not reduce the share of GNP that will be transferred to retirees tomorrow; however, current saving directed toward capital formation will help to ensure that overall incomes in the future will be large enough to provide benefits to retirees without denting the standards of living of their children too deeply, if at all The current social security system, when used properly, has such a focus and affords an opportunity for today's workers to lighten the burden on the workers of the next generation.

Pay-as-you-go financing does not have that focus Rather, each year, workers and employers contribute only enough to cover the cost of providing benefits to current recipients and to maintain a contingency reserve sufficient to carry the system through periods of poor economic performance Thus, returning to pay-as-you-go now would confer a significant windfall on the baby boomers who, in effect, would benefit doubly from the size of their age cohort Given their numbers, each would make a disproportionately small contribution during his or her working years to the retirement of their elders Yet in retirement, each would expect to receive full benefits, which could come only at a disproportionately high cost to their children At that time, pressures may well emerge to stretch out benefits by, for example, increasing the retirement age to reflect rising life expectancies

Linking an individual's benefits to his or her contributions has generally been considered equitable and desirable. Under the present system, the current generation of workers and the next will face the same OASDI tax rate of 12.4 percent, summing the employee and the employer shares. Assuming that benefits evolve according to existing laws--and that social security revenues are set aside, rather than used to lower other taxes or raise other outlays--the system moves in the direction of actuarial soundness, it confers no windfall gains or unforeseen losses on any particular generation. Accordingly, it offers some assurance to current and future workers that the government will keep its promises.

Senator Moynihan's proposal cuts the OASDI tax rate to 10 2 percent of covered wages in the 1990s However, as his bill makes clear, with pay-as-you-go, rates will have to rise sharply once the baby boomers begin to retire, the proposed rate for the years 2025 through 2044, for example, is 15.4 percent. Support for the system may well erode when the next generation is asked to take on a tax bill that their parents were unwilling--or too short-sighted--to assume during their own working years.

The choice of financing mechanism can also influence the mix of federal taxes Indeed, the increase in the share of payroll taxes in total revenues--and the regressiveness of these taxes--is frequently cited as a reason to return to pay-as-you-go financing However, looking at just the tax side presents an overly narrow view of the relationship between social security and the distribution of income in the United States When considered from the perspective of an

individual's lifetime--and when the formula for benefits as well as contributions is taken into account--social security clearly appears progressive

The numbers are striking  Consider individuals who retire this year at age 65 after working forty years. All anticipate receiving a benefits annuity that equals or exceeds in present value terms the sum of lifetime social security contributions plus accumulated interest The return for low-income workers, however, is especially great  In fact, the average minimum-wage worker can expect benefits that--relative to contributions--are roughly 1-1/2 to two times as large as those received by persons with above-average earnings

In any event, although the current system assigns them a leading role in providing retirement incomes in coming decades, the trust funds are only part of the story  In reality, the social security reserves are merely a bookkeeping entry within the federal sector Ultimately, their size matters only to the extent that they lead to smaller overall federal budget deficits--or larger total surpluses--and thus to higher national saving than would otherwise be the case.

At present, the contribution of the trust funds to national saving is greatly diluted by the large deficits in the rest of the budget. As long as the non-social security deficits remain sizable, Senator Moynihan and others are correct in pointing out that we are doing little to solve the future retirement problem  If, however, actions are taken to bring the rest of the budget into balance, the trust funds will no longer be financing current government consumption, but will translate dollar-for-dollar into national saving

Where in the total unified budget the saving takes place--in social security or elsewhere--is of secondary importance What matters in terms of reaching our longer-term growth objective is the government's net contribution to national saving. The important policy issue in the current context, therefore, is whether any of the major proposals regarding social security will help to achieve that goal. For example, is the federal government more likely to shift toward a position of positive net saving if social security is returned to pay-as-you-go financing? Given the large revenue loss implied by the plan, I think not

Another proposal is to move the social security system fully "off-budget," so that the trust funds would be excluded from the official summary budget figures and from the setting of deficit targets. Unlike Senator Moynihan's plan, a switch in budget accounting systems in isolation would not change the government's contribution to national saving and thus would have no direct effect on the economy. But the proposal raises other concerns

First, splitting off social security--or any other program--would highlight a distinction that has little macroeconomic or analytical significance Regardless of which numbers are reported, government saving or dissaving would continue to be well-approximated by the surplus or deficit in the total federal budget as currently defined in the National Income and Product Accounts, a close variant of the total unified budget.

Moreover, the way budget numbers are presented can influence public perceptions of important fiscal issues and thus--for good or

ill--shape the debate among policymakers As a consequence, methods of accounting and presentation can play a role in determining the size of the overall deficit or surplus. In particular, I fear that adopting a system that draws attention to the surpluses in the trust funds might foster the illusion that we already are putting enough money aside to meet future obligations. Furthermore, it would tend to remove social security from the broader fiscal policy debate.

In large part, my concerns are grounded in the analytical issues I discussed earlier. But they are compounded by a technical factor that affects the interpretation of the commonly cited statistics on the social security trust funds For example, the Congressional Budget Office projects that the annual surplus in the OASDI trust funds will increase from $66 billion in fiscal 1990 to $128 billion in fiscal 1995 But, as CBO points out, fully half of the difference between those two figures is accounted for by the interest received on the trust funds' holdings of government debt, which is forecast to grow from $16 billion to $50 billion over that period The latter figure represents nearly 0.7 percent of the GNP projected by CBO for that year. Moreover, in their report for 1989, the Social Security Board of Trustees projects that ratio to rise to 1.3 percent of GNP by the year 2030. Such intragovernmental interest payments are both an inflow to the trust funds and an outlay from the general funds and wash out when the accounts are consolidated. But, because they result in an overstatement of both the saving taking place in the trust funds and the dissaving elsewhere, they can contribute to a significant misreading of saving trends when either part of the budget is considered in isolation

The figures over longer time horizons are even more dramatic, magnified by the wonders of compound interest; but the story is much the same. For example, the Social Security Trustees project that net inflows to the trust funds--apart from interest--will remain at their current level of about 1 percent of GNP over the next twenty years, then turn sharply negative once the baby boomers retire in force However, because of the surging interest payments, trust fund assets will continue to grow for a time, reaching a peak of about $12 trillion around the year 2030 Excluding interest payments, those assets will rise to only about $3 trillion around the year 2020 before turning down. Thus, the peak trust balance in 2030 will essentially represent interest receipts that are offset elsewhere in the federal accounts While the contribution of social security to national saving is sizable--over both the medium and the long term--it is clearly much smaller than the conventional calculations suggest

More generally, I fear that moving away from the unified budget concept will impede the achievement of the sizable deficit reductions that the nation so sorely needs. The arguments are well-known Many of them center on social security itself and on the inevitable pressures that would develop to expand benefits or cut payroll taxes if the system were not subject to the discipline of an overall deficit constraint In the absence of offsetting changes elsewhere in the budget, such actions would reduce national saving and over time worsen the burden on the generation after the baby boom

Moreover, responsible budgeting requires a comprehensive framework for setting priorities and assessing competing claims on

national resources That function currently is filled by the unified budget process. If deficit targets were to be set exclusive of social security, they could be met--at least in part--by moving related programs into the social security account or by shifting other trust funds off the books Such actions would shrink the on-budget deficit but would not reduce federal demands on private saving or on credit markets.

Most important, we must not allow the choice of a budget accounting system to divert attention from the pressing need for meaningful deficit reduction In other words, the Congress must take actions to set the federal government's claim on saving--however the budget deficit is measured--firmly on a downward track. Making a serious commitment to eliminating the unified deficit within the foreseeable future is an essential first step, and meeting that commitment will be a formidable challenge But it is just a first step If households and businesses continue to save relatively little, then the federal government should compensate by moving its budget in the direction of greater surplus.

Let me reiterate that the source of our fundamental budget problem is the persistence of enormous deficits at a time when demographic trends call for increases in private and government saving. Undoing a social security system that is the result of many years of careful consideration and compromise, in my judgment, will not address our fundamental policy needs Indeed, it could be counterproductive