Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Task Force on Economic Policy, Projections, and Revenues
Committee on the Budget
U.S. House of Representatives

May 18, 1989

NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EDT), Thursday, May 18, 1989.

Mr. Chairman, I am pleased to appear before this task force to discuss the financing of Social Security and its relation to federal fiscal policy. My testimony will summarize the current outlook and identify the major options that the Congress may wish to consider over the next few years.

Under current policies, the share of our economy's resources devoted to the aged will increase substantially in the next century as a consequence of the baby boom of 1946 to 1964 and recent low birth rates. These higher costs should not constitute an unmanageable burden on future generations of Americans, who will be substantially wealthier than we are today. Nonetheless, the projections raise the question of whether the nation should take additional steps to prepare for the transition to what will be a permanent rise in the average age of the population.

One response is to scale back our future commitments to the elderly. A second is to consider policies that will expand the pool of resources available to finance the baby boom's retirement. Such policies might take the form either of increasing saving (which could add to the private capital stock) or of shifting federal spending toward investment in education, research, health, and infrastructure (which could increase the productivity of tomorrow's workers).

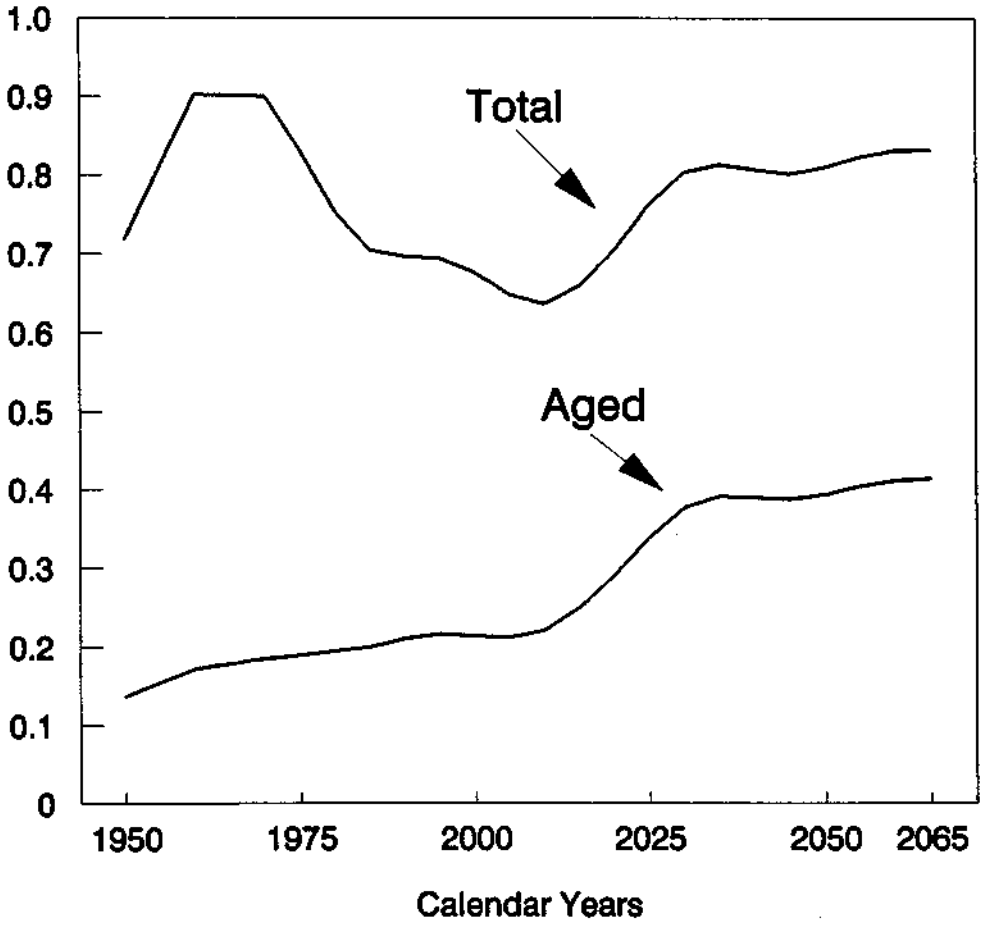
THE DEMOGRAPHIC BACKGROUND

Let me start by describing the demographic picture. In the 20 years after World War II, the American birth rate was relatively high. In 1957, at the peak of the postwar baby boom, women were having an average of 3.7 children over the course of their childbearing years. But soon the fertility rate began to fall sharply, reaching a low of 1.7 children per woman in 1976. Since then, the fertility rate has risen to a level currently estimated at 1.9 children per woman.

Projected Increase in Aged Dependency

The infant born in 1945 will reach age 65 in the year 2010. During the following 20 years, as the rest of the baby-boom generation reaches retirement, the proportion of the American population that is of retirement age will increase rapidly. The Social Security actuaries project that, under their intermediate assumptions, the ratio of those aged 65 and over to those aged 20 to 64 will rise from 22 percent in 2010 to 38 percent in 2030. This increase is not a temporary bulge but is projected to be permanent, as illustrated in Figure 1.

Figure 1. Dependency Ratios



SOURCE: Social Security Administration.

NOTE: Data are plotted for every fifth year.

Those aged 20 to 64 are commonly considered to be of working age. The ratio of the over-65 group to those aged 20 to 64 is therefore a rough measure of the cost that those of working age must bear to support those in retirement. This ratio is commonly called the "aged dependency ratio." A broader measure of dependency, termed the "total dependency ratio," also includes the population under 20 as well as that over 65. The total dependency ratio reached 90 percent during the 1960s, when the baby boom was in its youth, as is also shown in Figure 1. Since then, it has fallen to about 70 percent. It is projected to fall a bit further, reaching a low of 64 percent around 2010, then to rise rapidly to 80 percent in 2030.

A caveat is in order here. Population projections are subject to considerable uncertainty. The birth rate is notoriously hard to predict, and mortality and immigration trends are not entirely foreseeable. We should therefore not attempt to fine-tune our current policies based on projections for the next century. Nevertheless, almost all of those who will be working in the year 2010 have already been born, making some substantial increase in the aged dependency ratio inevitable.

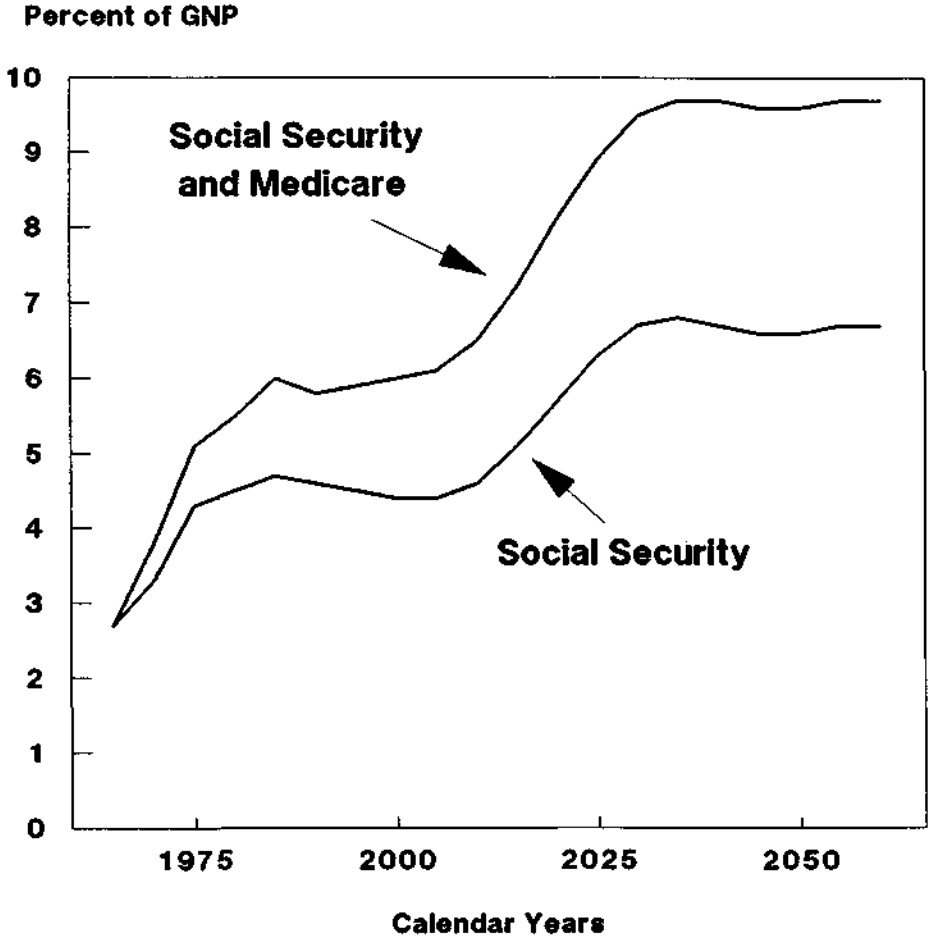
Projected Increase in Social Security Costs

Through the Social Security and Medicare programs, the federal government has assumed a major responsibility for the well-being of the retired population. Social Security provides almost everyone with basic retirement income protection, on which private pensions and savings may build. Social Security has also helped reduce the poverty rate of the aged to below the level of the overall population.

This great success, however, has not been cheap. Social Security benefits grew from 0.2 percent of gross national product (GNP) in 1950 to 2.5 percent of GNP in 1965, when Medicare was established. By 1980, benefits for Social Security and the Hospital Insurance portion of Medicare together amounted to 5.5 percent of GNP. This growth in benefits has been financed by comparable increases in payroll taxes, which for many taxpayers now exceed their personal income taxes.

With the current structure of Social Security benefits, the cost of the federal government's responsibility is projected to grow in line with the growth in the over-65 population, as illustrated in Figure 2. Social Security cash benefits are projected to grow from 4.6 percent of GNP in 2010, about the current level, to 6.7 percent of GNP in 2030. Including Hospital Insurance, outlays are projected to rise from 5.7 percent of GNP today to 6.5

Figure 2. Social Security and Medicare Outlays



SOURCE: Social Security Administration.

NOTE: Data are plotted for every fifth year.

percent in 2010 and 9.5 percent in 2030. (The Hospital Insurance figures exclude catastrophic health insurance, because it has not yet been incorporated by the Medicare actuaries in their long-run cost projections.)

Although government spending for the elderly exceeds government spending for children, the baby-boom generation's retirement is not the first time this cohort has had a major impact on the public sector. As the baby boomers entered school, state and local government expenditures on education rose from 2.5 percent of GNP in 1950 to 5.9 percent of GNP in 1970. This increase of three percentage points is similar to the projected increase in Social Security and Medicare costs between 2010 and 2030.

THE FISCAL SITUATION

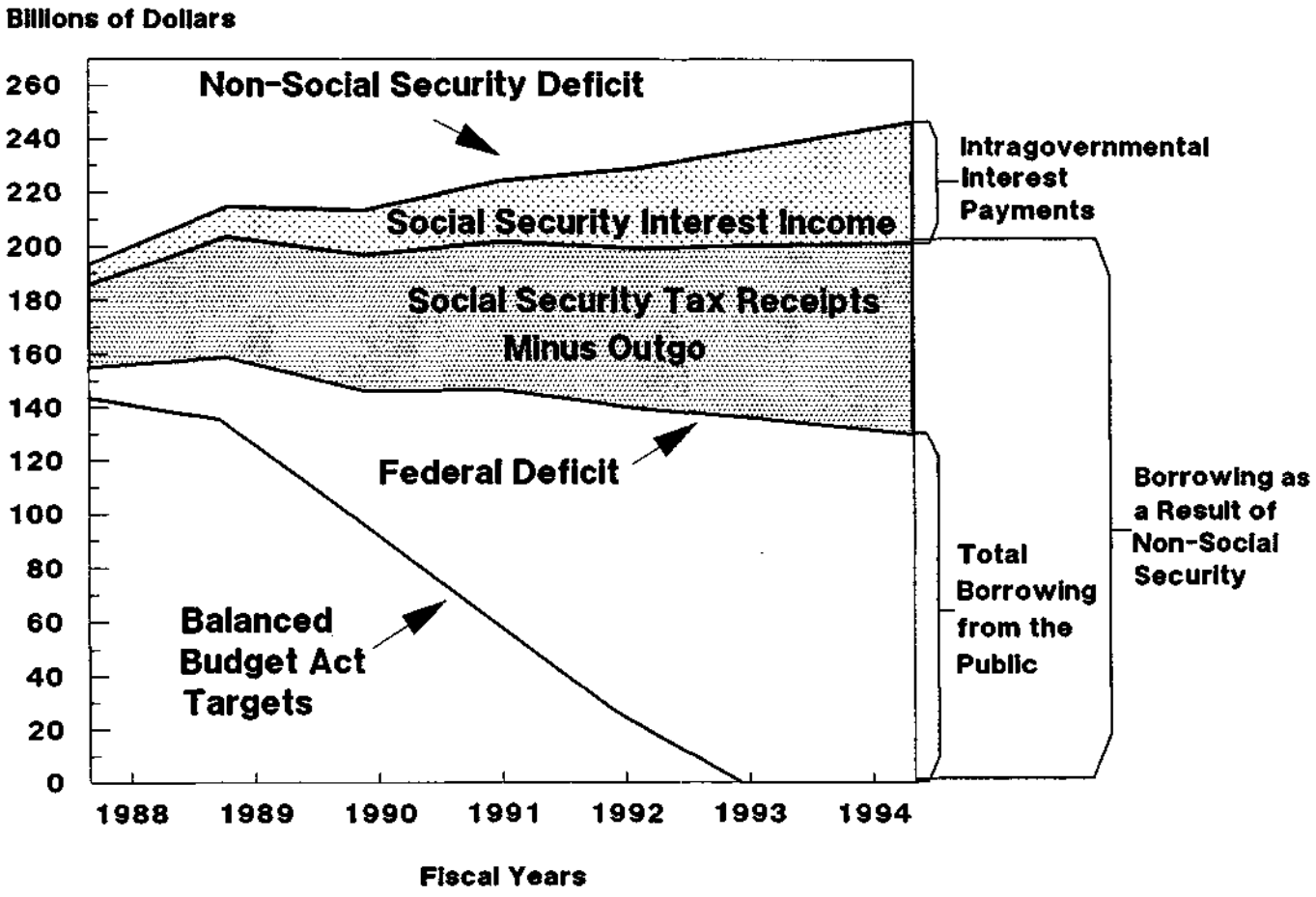
As a result of the Social Security Amendments of 1977 and 1983, the tax revenues of the Old-Age and Survivors Insurance and Disability Insurance trust funds have begun to exceed what is needed to pay current benefit costs and administrative expenses. In the short run, some analysts believe that this excess is helping to hold down the total federal government deficit. How this excess should be treated in the long run is one of the questions that the task force has asked me to address.

Baseline Budget Projections for 1990-1994

CBO estimates that the federal government's total deficit, including Social Security, will amount to about $159 billion in fiscal year 1989. CBO's baseline budget projections--which assume no changes in tax or entitlement laws and constant real spending for discretionary appropriations--show a deficit of $146 billion in 1990 and 1991, declining only slightly to $130 billion in 1994. These projections exceed by increasing amounts the targets specified in the Balanced Budget Act, as shown in the two bottom lines of Figure 3.

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, determines the government's borrowing needs and its impact on credit markets and the economy. Therefore, Social Security is included in the totals for determining if the Balanced Budget Act targets are met. The Balanced Budget Act, however, also declared the two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance--to be off-budget and protected Social Security benefits from being cut in the reconciliation process. The Hospital Insurance trust fund is scheduled to be taken off-budget in 1993.

Figure 3. CBO Baseline Budget Projections



SOURCE: Congressional Budget Office.

This treatment of Social Security in the budget often leads to confusion in identifying what the program spends, what the trust funds receive in income, and how Social Security relates to the total federal deficit. The Social Security trust funds receive income from a variety of sources. They collect taxes from wage and salary workers and their employers, and from the self-employed; payments from the federal government as an employer of covered workers; general fund transfers representing the amounts collected from taxes on Social Security benefits; interest on their holdings of federal securities; and other, smaller sources. Only the first of these--revenues from the public--is shown as off-budget revenues. The remaining income to the trust funds is recorded as offsetting receipts on the outlay side of the budget. As a result, total off-budget outlays (estimated by CBO to equal $211 billion in 1989) are substantially less than Social Security benefit payments and administrative expenses (which total about $233 billion).

The widely cited Social Security surplus is the same, whether measured as the off-budget surplus or as the gap between trust fund income and outgo. This surplus climbs from $56 billion in 1989 to $117 billion in 1994. The trust fund surplus, however, overstates Social Security's effect on the total federal deficit and its effect on the government's overall financing needs. A more useful measure for this purpose would ignore transfers within the government, primarily interest from the Treasury, and focus instead on Social Security's dealings with the public. Excluding interest, Social Security's contri-

bution to holding down the total deficit looks much smaller--about $45 billion in 1989 and $72 billion in 1994--as shown in the upper half of Figure 3.

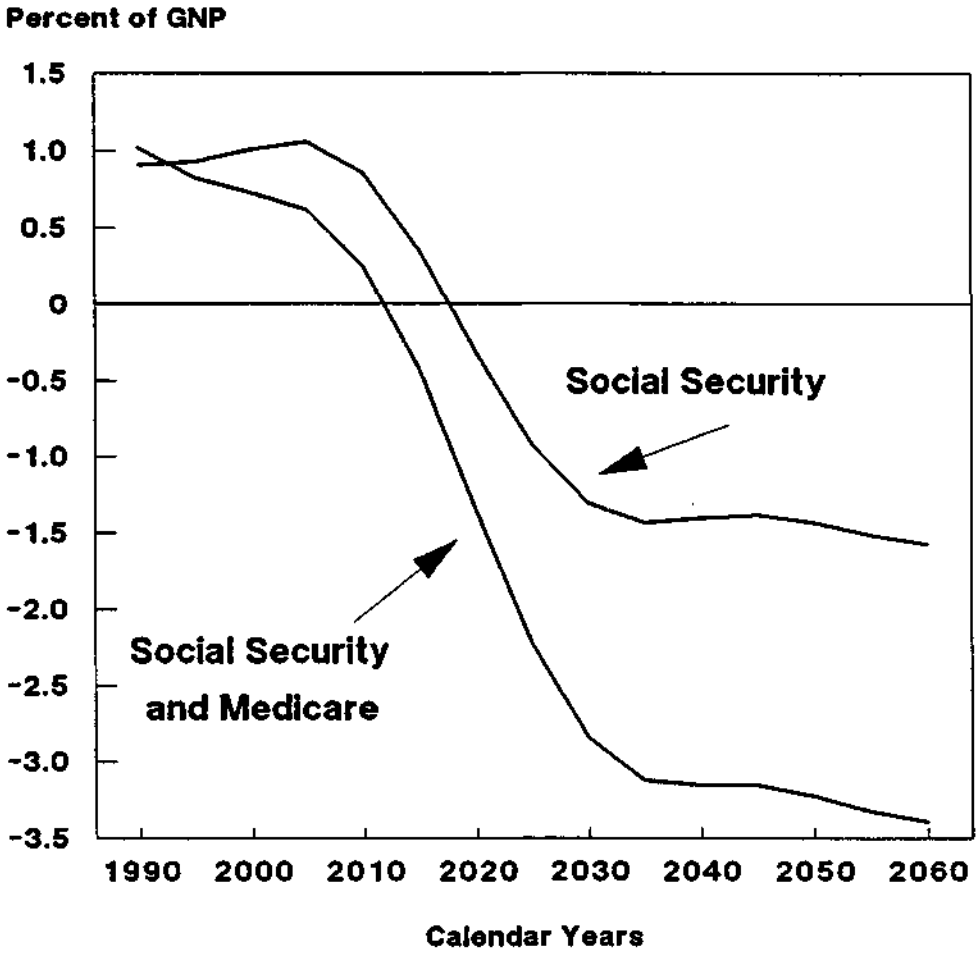
Longer-Run Social Security Projections

Social Security receipts from payroll taxes and income taxes on benefits are projected to exceed outgo for quite some time, as illustrated in Figure 4. Tax receipts will grow at roughly the same rate as GNP, because no Social Security tax rate increases are scheduled after 1990. Outlay growth, as noted previously, follows the growth in the number of beneficiaries. As a result, tax receipts will exceed outgo through about 2020.

Including the Hospital Insurance program, the difference between income and outgo is smaller. Because of increases in the cost of medical care, the excess of tax receipts over outgo is projected to decline from its current level of 1 percent of GNP. For OASDI and HI together, the excess is projected to average about 0.8 percent of GNP in the 1990s and 0.6 percent of GNP in the 2000-2010 period. From about 2015 on, however, outlays for benefits will exceed income from taxes by increasing amounts.

As the trust funds build, their reserves are invested in U.S. Treasury securities. When the baby boomers begin to retire, however, Social Security

Figure 4. Social Security Tax Receipts Minus Outgo



SOURCE: Social Security Administration.

NOTE: Data are plotted for every fifth year.

will have to redeem its holdings of federal securities in order to pay the promised retirement benefits. The Treasury will then have to obtain funds to redeem these bonds. One way to do this would be to cut spending or raise taxes enough to generate a surplus on the rest of the budget sufficient to finance this flow. The only other alternative is to borrow more. Returning Social Security to a pay-as-you-go basis would not change anything. Tax increases, spending cuts, and borrowing would still be the only sources of funds to pay for the growth of benefits. In short, the retirement income of the baby-boom generation in the next century will have to be provided out of the economic resources available at that time.

CHOICES FOR THE FUTURE

Choices will therefore have to be made about how to share the future output of the American economy between active workers and retirees. The demographic projections indicate that we will need to devote considerable resources to fulfilling our current commitments to the elderly in the next century. Some analysts are concerned that the rising need for retirement income will be hard for the economy to handle. Their worry is not that the government would have trouble raising taxes or borrowing more to pay Social Security benefits. The government's power to tax assures that it can raise the funds it needs. Instead, the concern is that the economy will not generate

enough income to provide a standard of living that both the families of active workers and retirees will consider adequate.

There are two ways to make these retirement income commitments easier to manage--first, by planning to reduce those commitments, and second, by taking steps to increase the future size of the economy or the wealth of the nation.

Reducing Benefit Commitments

Social Security benefits are currently designed to equal about 40 percent of an average worker's previous earnings if he or she retires at the normal retirement age. While the ratio of benefits to prior earnings (termed the "replacement rate") is scheduled to remain constant for future cohorts of retirees, the real value of the benefits will grow for successive retirees as real earnings rise. Between now and 2030, for example, the benefits of the average earner at normal retirement age will increase by about 65 percent in real terms.

Some Social Security advocates contend that the current schedule of Social Security benefits represents a commitment that cannot be changed without breaking faith with current workers. Certainly, Social Security

benefits represent a critical part of retirement income and should be altered only gradually and with substantial advance notice. Yet Social Security benefit rules are not written in stone. The 1983 amendments, for example, increased the age of eligibility for full retirement benefits from 65 to 67. The amendments did so in stages, however, starting for people who turn 62 in the year 2000. When fully phased in, this change will amount to a 12-1/2 percent reduction in benefits for a person retiring at age 62.

Others contend that maintaining constant replacement rates is appropriate public policy because people measure their well-being in relative terms rather than in absolute dollars. Those reaching age 65 in 2010 or 2030, they contend, will no more wish to see a drop in their living standards at retirement than do those retiring today. On the other hand, since future retirees will be much better off than current retirees, it can be argued that they will be in a better position to provide for their own retirement through pension plans and private savings and may need to rely less on public benefits.

If benefit commitments are to be reduced, several possibilities are available. One way is to increase the age of eligibility for unreduced retirement benefits even more than is contemplated in current law, and to increase the age of eligibility for Medicare commensurately. This change might be coupled with increasing the age of initial eligibility for Social

Security, so that people are encouraged to work longer and not retire on inadequate benefits. An alternative approach is to slow the growth of benefits by making changes in the benefit formula or in the income-tax treatment of benefits.

Increasing Future Output and Wealth

As an alternative or a complement to reducing future benefit commitments, our society could take steps now to increase the size of the economy or the wealth of the nation in the next century. Expanding the economy will not reduce the share of GNP devoted to Social Security benefits, but it would allow both workers and retirees to have higher standards of living than would otherwise prevail. Three ways of increasing the economy's growth deserve mention--increasing private saving, reducing the government deficit or even running a surplus, and increasing government spending on investment activities (while not increasing the deficit).

Increasing Private Saving. One way of increasing productivity growth is to use federal policy to encourage private saving, which has recently fallen to very low levels by both historical and international standards. If it were successful, this strategy would make more funds available for investments in business capital in this country, or for investments abroad. Both of these outcomes

would contribute to economic growth and increase the income and living standards of future generations. Unfortunately, however, public policies to encourage private saving seem to have met with little success in the past.

Reducing the Government Deficit. A more direct and certain way of increasing national saving would be to reduce government dissaving--that is, to reduce the federal deficit. About half of the overall decline in net saving in the United States in the 1980s occurred in the public sector. The sum of federal, state, and local deficits has increased dramatically as a share of national income since 1980. The federal government has been the primary culprit.

In 1988, the federal deficit absorbed three-fifths of net private saving. If the federal budget were balanced, this saving would be available for investing in business plant and equipment at home, or for reducing our indebtedness to foreigners. The federal government could go even further than a balanced budget, which is the Balanced Budget Act's requirement for 1993, and move the budget into surplus. Running a surplus, of course, would require even more spending reductions or tax increases than meeting the current deficit targets, which are already proving very difficult to reach.

CBO's 1989 annual report analyzed the effect of having the federal government run a surplus of 2 percent of GNP after 1993 instead of a budget

balance. Initially, private and public consumption would be reduced by a little more than 2 percent, as the government reduced spending or increased taxes. The higher saving would raise capital accumulation and output, and eventually consumption would also increase. But there is no way to estimate with any certainty how long this would take, or how much consumption per capita would increase in the long run. Depending on how much the additional investment contributed to the economy's output, between five and ten years would be required for per capita consumption to be as high as it would have been had the government not run a surplus. By the year 2040, per capita consumption could range from 2 percent to 14 percent higher than would be the case without the budget surpluses.

Increasing Government Investment. A third way of increasing the growth of the economy would be to reduce private or public consumption and to spend more on government investment. The additional government investment could be financed either by reducing other government expenditures or by raising taxes, which would reduce private consumption.

If properly targeted, some federal expenditures--such as those for highways and airways or research and development--may contribute as much or more to growth in output as does private investment spending. The government could also spend more on the education and health of tomorrow's workers in ways designed to increase their productivity. Even some

spending that does not directly add to future gross national product may contribute to broader measures of the standard of living. After all, additional investment in new factories and equipment may provide scant satisfaction if social and economic inequalities grow, if drugs and violence threaten, and if our environment deteriorates.

CONCLUSIONS

Three conclusions may be drawn from this analysis.

First, the important choice facing the nation is not really the question of how to finance Social Security but rather that of what the federal government's overall fiscal posture should be. Social Security could operate equally well with some buildup of reserves, as is currently provided, or on a pay-as-you-go basis, as was the case for most of its history. In either approach, the financial support for Social Security will be provided not by the accumulation of reserves but by the productive capacity of the economy.

Moreover, regardless of how Social Security is financed, the appropriate measure of the federal government's fiscal stance is the total deficit, including Social Security. If the decision is made to move the total budget into surplus after 1993, it makes essentially no economic difference if that

surplus is credited to the Social Security or the non-Social Security part of the budget. Politically, there are arguments on both sides of the issue. Some proponents of a budgetary surplus contend that surpluses could be more easily justified in Social Security than elsewhere in the budget. Others argue that Social Security surpluses are unsustainable because they create a temptation to liberalize benefits.

The second conclusion is that deciding how to prepare for the baby boom's retirement is a matter of political choice rather than one of economic or demographic necessity. It is a choice involving value judgments about the relative well-being of current and future citizens as well as about the distribution of the tax burden among and within cohorts. One can argue that each generation should pay for the government goods and services it consumes over its lifetime. Such a rule would argue for scaling back future benefits, or for taking steps to increase future incomes and wealth. Alternatively, one can argue that future generations will be far better off than current ones, and that they will easily be able to support the projected increase in retirement costs. By the year 2030, for example, real GNP per person is projected to be about 65 percent higher than it is today. Devoting an additional 3 percent of this higher GNP to the aged may not seem a great imposition.

Finally, if some action is to be taken to deal with projected increases in Social Security costs, the choice need not follow a single path. We do not have to rely exclusively on reducing benefit commitments, saving more, or increasing public investment. It may well make sense to do a little bit of all three.