Statement of
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before the
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Committee on Ways and Means
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NOTICE

This statement is not available for public release until it is delivered at 1:00 p.m. (EST), Tuesday May 10, 1988.

Mr. Chairman, I am pleased to appear before this subcommittee to discuss the economics of the baby boom's retirement. Over the next two decades, the number of people over 65 years of age will fall relative to the working population. For the subsequent two decades, the situation will reverse itself as the growth of retirement-aged people substantially exceeds that of the projected work force. In my testimony I will examine what this pattern implies for the economy and specifically for federal policy towards national savings and investment.

Assuming that members of the baby boom generation will begin to retire two decades from now, as projected by the Social Security Administration, there will at that time be a great many claimants on the U.S. capacity to produce (or import) consumer goods and services.1/ Specifically, the baby boom generation will continue to claim its share of consumption just as it ceases contributing to that production. Two major ameliorative factors would ease the pressure of competing demands for consumer goods:

- If the economy's capital stock and productive potential grows rapidly by 2010, the work force would be capable of producing a much larger national output, thereby making it easier to

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1/ The possibilities of delayed retirement in the baby boom generation are discussed in the accompanying testimony of Royal Shipp.

transfer a growing share to retirees. Moreover, such a large capital buildup would allow a major diversion of resources during the baby boom retirement years out of investment goods and into the consumer goods sector.

- U.S. citizens could have built up enough claims on foreigners by 2010 that U.S. productive capacity could be supplemented during the baby boom retirement years by a high level of imports, paid for by the previously accumulated claims.

What is common to both of these factors is that they would require that higher shares of GNP be devoted to savings and investment during the next two decades than in recent years. Growth in the U.S. capital stock and in net U.S. holdings of claims against foreign assets would mean higher levels of investment (domestic or foreign) by the United States. The only way to obtain more investment (public or private) is to reduce consumption of (public or private) consumer goods and services. If the middle-aged United States today visited a financial planner, the bottom line of the computer printout would read: save more for retirement, while you are still working.

How Are We Doing?

The recent history and prospective outlook for the U.S. economy on the savings and investment front is not encouraging. Indeed, we have been experiencing economic behavior that is very much the opposite of the high savings and investment scenario just described.

Private savings rates--by households, business and pension funds held by state and local governments--have deteriorated in the 1980s to well under the average following the Second World War. This decline happened despite very high real interest rates, numerous tax subsidies to encourage savings, and a recent reduction in the number of young adults who traditionally are low savers.2/ As the baby boom enters late middle age in the next two decades, private savings rates might be expected to rise to some degree.

The story in the public sector is worse. The federal government, which can contribute to national savings by running an excess of income (taxes and other receipts) over

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2/ For a discussion of some of the tax incentives and a useful bibliography, see Edward Gramlich and Eric Toder, "The Impact of Tax Reform on Savings and Investment: Some Early Evidence," National Tax Association-Tax Institute of America, Proceedings of the Eightieth Annual Conference, 1987 (forthcoming).

outgo (outlays), has done quite the opposite. Federal deficits in the 1980s so far have averaged 4.4 percent of GNP compared with 1.1 percent over the previous 30 years. This means that federal borrowing is increasingly competing for dwindling private savings, rather than augmenting them. (Such behavior by the federal government would be of little concern in a savings and investment context if the growing deficit were attributable to growing federal outlays for education, training, and infrastructure, for these also contribute to future productivity. But the growth in the deficit cannot be attributed to such factors.3/) State and local governments have run an approximately balanced budget (except for the pension reserves mentioned above), and this situation can be expected to continue.

The Congressional Budget Office's (CBO's) latest five-year baseline projection--showing the course of the deficit under current policy--is only mildly encouraging. These baseline projections are not forecasts of future budgets, which will doubtless include numerous policy changes, but are a benchmark against which to judge the budgetary consequences of proposed legislation. From an average deficit of 4.4 percent of GNP in the first seven fiscal years of the 1980s, the deficit share is projected to average 2.9 percent of GNP

3/ See Congressional Budget Office, Trends in Public Investment (December 1987).

between 1988 and 1993, reaching 2.1 percent of GNP in the final year.4/ While this decline represents an improvement, it results in part from more rapid economic growth than can be expected in the future as the economy reaches full capacity. The underlying pace of lowering federal deficits is slow.

Recent trends in U.S. economic relations with the rest of the world are also the reverse of what would help in preparing for the baby boom's retirement. When I referred earlier to building up claims against foreign assets over the next 20 years, that is equivalent to exporting more goods and services than we import during that time. A current export surplus means that foreigners would be increasing their debt to U.S. residents--which is another way of saying we would be increasing our claims on them.

Recent history shows exactly the opposite behavior in the foreign sector of the U.S. accounts. In 1987, the U.S. imported $141 billion more than it exported, continuing a string of five years of increasingly disappointing foreign trade performance. Should the United States not reverse its net debtor position in the next 20 years, we would face the prospect in the baby boom retirement years of having to

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4/ Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1989-1993 (February 1988).

divide the U.S. national output not only among the work force and its children and the growing ranks of the retired, but also of having to send part of it abroad, as foreign holders of U.S. assets cash in their dividends and interest. Some improvement in the foreign sector accounts appears likely. Foreign private investors have already shown flagging interest in dollar-denominated securities, and exports are rising. However, without an increase in domestic savings a decline in foreign capital inflows will manifest itself in declining domestic investment--once again, an outcome that would work against preparing for the baby boom's retirement.

Longer Perspectives on the Deficit

Of course, the shorter-term trends in the federal deficit do not preclude a vast turnaround in federal finances before the baby boom begins to retire. We still have 20 years before that day arrives.

The CBO baseline methodology for five-year projections provides a less satisfactory point of reference if it is blindly extended for another 15 years. On the revenue side, our current tax laws should yield about 19 1/2 percent of GNP each year over the next five years, not far from the historical average. Beyond that time, personal income tax revenues as a share of GNP should rise slightly as real

growth causes some bracket creep. (Certain excise taxes, however, that are levied on a per-item basis tend to shrink as a share of GNP.) Whether "current policy" incorporates such an upward creep or really is the 19 1/2 percent share envisioned in the next few years is an unanswerable question. On the spending side, longer-term extrapolations would show that by 2000, under current law, entitlement spending would be about 11 percent of GNP (up slightly from the current 10.7 percent), with declining social security retirement costs being offset by rising Medicare and Medicaid spending.5/ The latter extrapolations are especially uncertain, however, because they depend on assumptions about medical care prices and about almost certain changes in federal policy, such as physician reimbursement.

Beyond revenues and entitlements, longer-term extrapolation of federal outlays is largely guesswork about foreign military threats and domestic needs. Expenditures for national defense were as high as about 10 percent of GNP at the peak of the Vietnam War, fell to under 5 percent of GNP in 1980, and are now about 6 percent of GNP and falling. Nondefense discretionary spending amounted to about 5 percent of GNP in the late 1960s and 1970s, but has dropped

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5/ See statement by Paul N. Van de Water, Chief, Projections Unit, Congressional Budget Office, to be given before the Subcommittee on Social Security, Senate Committee on Finance, May 13, 1988.

to under 4 percent currently. If the roughly 10 percent of GNP recently consumed by combined discretionary defense and nondefense spending is a reasonable guess for the longer term, then that projection reveals the difficulty before us. With entitlements at 11 percent of GNP by 2000, an additional 10 percent of GNP for discretionary spending, and an allowance for net interest (minus offsetting receipts) of 1.5 percent of GNP, outlay rates (around 22 1/2 percent of GNP) will be well above the projected revenue share of just over 19 1/2 percent in the longer run.

Too often, analysts have taken CBO's short-term methodology--which is to hold discretionary spending constant in real terms--and extended it to the distant future to arrive at pleasing conclusions. But not allowing discretionary programs any part of an assumed real growth in GNP is a severe assumption, implying a constantly shrinking public goods share of GNP. Under the alternative assumption of fixed GNP shares employed above, the prospect is less pleasing: in the absence of policy change, the deficit could continue until the end of the century.

A Long-Term Target for the Deficit

Discussions of the pros and cons of various deficit targets in the past have been dominated by short-run (cyclical)

considerations. While stabilization policy continues to be an important constraint on fiscal policy, the decidedly longer-term savings and investment considerations discussed in this testimony raise the issue of fiscal policy norms for the long run.

To give definitive advice on such norms involves reaching settled conclusions about a number of factors already alluded to. Since total national savings affects investment, a clear idea about private savings rates would help to settle on optimum public saving rates. And since the ease of transferring output from the working population to the elderly depends on the level of real output, we would need to know the various noninvestment factors--managerial improvements, innovations, mobility of the population, and so forth--that contribute to output. For the most part, these factors are among the most unsettled areas of economic research. Saving rates of different age groups have proven hard to predict and explanations of past output growth have not satisfactorily explained all of the productivity slowdown suffered (all over the developed world) since the early 1970s.

Nonetheless, as attention has turned to longer-run considerations and to an impending sharp rise in the Social Security surplus, various fiscal norms have been mentioned.

(In the following discussion--as in all of the previous parts of this testimony--"the deficit" or "the budget" means the total federal deficit, including social security.) In order of increasingly ambitious plans:

- One extreme would be a continuation of the budget policy of the postwar period, with continued deficits in the 1 percent to 1 1/2 percent of GNP range. This might be thought of as a possible end product of the slow decline in deficits under current policy. During the early years of the next century, when Social Security surpluses grow very large, such a standard implies deficits in the rest of the budget as great as they were in the mid-1980s.

- A second plan would be for a balanced federal budget--as, for example, is incorporated in the final year of the Balanced Budget and Emergency Deficit Control Act Reaffirmation of 1987 (Gramm-Rudman-Hollings). Since the Social Security program under current law is projected to have large surpluses for the next 20 years, this norm implies that the rest of the government could remain in deficit, but just enough to offset growing Social Security surpluses.

- At the opposite extreme is the goal of balancing the part of the federal budget that does not include Social Security. The implication of this target is that the total government would save the amount now projected in the Social Security surplus under current law.

With the huge Social Security surpluses now projected, there are clearly several intermediate stopping points between the extremes besides a balanced budget. Deciding on where the government should aim depends on the aforementioned guesstimates about nonfederal savings and productivity changes, and on the relative importance assigned to easing the burden of the baby boom's retirement compared with the short-term losses in consumption that would result from any vigorous deficit-cutting regime.

On-Budget Versus Off-Budget: Is that the Question?

Discussion of the critical issue of how an economy with a low saving rate is to be turned around appears to have been diverted into a discussion of how to display the Social Security accounts in the federal budget.

Currently Social Security is "off-budget" as a result of the Gramm-Rudman-Hollings Act. However, in setting fiscal norms for the next five years, this same act requires that the Social Security accounts be incorporated into the budget deficit calculations, making Social Security, in practice, a part of--if not on--the budget. Current projections show rising Social Security surpluses, but increasing deficits for the rest of the government as a whole.

Some contend that keeping Social Security off-budget and setting fiscal goals exclusively for the remaining government accounts would help the government do what is needed: raise taxes or lower spending. Others contend that nothing is wrong with including Social Security (which, in any event, cannot really be ignored) as long as ambitious goals, such as running a total government surplus, are not ruled out. Under this view, with a budget defined to be inclusive and the budget norms made flexible, the government would be acting on the most complete information.

The main difference between these views lies in their assessment of how political players will react to different budget presentations. In weighing these views, we have no direct historical evidence to draw upon--these social insurance surpluses are a new event in our history--so all predictions about the behavior of the Congress, the

President, and the electorate rest on speculation. Whatever the process and outcome of this debate, however, attention should not be diverted from the critical issues for national savings raised by the demographic changes taking place.