

GAO

Testimony

For Release  
on Delivery  
Expected at  
2:00 p.m. EST  
Monday  
February 5, 1990

**THE QUESTION OF ROLLING BACK  
THE PAYROLL TAX:  
UNMASKING THE DEFICIT ILLUSION**

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Before the  
Committee on Finance  
United States Senate



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## SUMMARY

The use of growing Social Security surpluses to mask the deficit in federal operations amounts to blue smoke and mirrors. It has encouraged avoidance of the hard choices that must be made if the government is to bring its fiscal operations closer to balance.

Despite the discipline the Gramm-Rudman-Hollings process was supposed to bring to deficit reduction efforts, the deficit in federal operations remains virtually unchanged since fiscal 1985. Congressional Budget Office projections show that if current policies continue, the general fund deficit will grow to over \$300 billion by 1995. Should that happen, general fund interest payments could become the largest single item in the federal budget and might well surpass defense and social security. Interest costs of this magnitude would severely hamper efforts to achieve major policy goals and to address unmet needs.

The Administration has offered a proposal which eventually would better highlight the masking effect of Social Security surpluses. But this proposal phases in gradually over the next 6 years. Even if all the assumptions underlying the Administration's budget are realized, the national debt would still rise by over \$1 trillion -- to \$4 trillion -- before the general fund is in balance. The CBO baseline projection shows the debt growing by over \$1.5 trillion over a similar period. Should Congress act to reduce Social Security payroll taxes to a pay-as-you-go level without offsetting budget cuts or provision for added revenue, an additional \$300 billion could be added to the national debt.

The burden of financing retirement benefits will increase in the future as the baby-boom generation retires. Adopting policies today that promote sustained growth in years to come will enable future workers to bear more easily this heavier burden while still enjoying a rising standard of living. Chief among those policies is bringing the deficit in federal operations closer to balance and using Social Security surpluses to increase national savings.

However, if we allow accumulating Social Security reserves to become an excuse for inaction -- if we continue the illusion that the deficit problem is being solved when, in reality, it is merely being hidden from public view -- then these surpluses will have no real economic meaning. Future workers will be no better off than if we had returned to pay-as-you-go financing and were forced to address the general fund deficit through other means.

To solve this fundamental problem, our political leadership must find a way to negotiate a multiyear, politically sustainable budget strategy. We hope that Senator Moynihan's proposal will provide the catalyst to compel such action.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our views on Senator Moynihan's proposal to return Social Security to a pay-as-you-go basis. This proposal forces the Congress and the American people to face squarely the budget deficit problem and to deal with the blue smoke and mirrors that have characterized our budget process for several years now. I would like to commend you, Mr. Chairman, for promptly scheduling these hearings, which provide an appropriate forum for airing these issues.

Last year, Senator Moynihan asked us to review the current Social Security financing plan. In our report<sup>1</sup> to him and later in this statement, I present our views on the potentially desirable economic effects of accumulating reserves as well as the implications of the current financing plan for federal budget policy.

I am pleased that a public debate has begun on these important issues. The caliber of the debate is important--it must be grounded in fact, not fiction. And, it must involve honest discourse. We have difficult financing decisions to make and serious fiscal problems to solve. We need to disclose fully the real status of our current fiscal affairs to make informed judgments. We must face the facts.

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<sup>1</sup>Social Security: The Trust Fund Accumulation, the Economy, and the Federal Budget (GAO/HRD-89-44, Jan. 19, 1989).

Senator Moynihan is correct in focusing attention on the extent to which Social Security reserves have masked the general fund deficit. I believe, in fact, that the luxury of these reserves has provided a convenient excuse for avoiding the tough choices needed to cut the general fund deficit. This discouraging story is told in table 1, which is attached to my statement.

The actual 1989 general fund deficit<sup>2</sup> was \$275 billion--\$8 billion larger than this deficit in 1985, the year before Gramm-Rudman-Hollings took effect. Despite the intended pressures of Gramm-Rudman-Hollings, we have failed to reduce the underlying deficit in government operations.

The value of the Senator's proposal is that it compels us to focus on numbers like these. Unfortunately, however, attention has been diverted by suggestions that his proposal would lead to cuts in Social Security benefits. This assertion is not correct. The Senator merely proposes to return Social Security to pay-as-you-go; which is how it has operated over most of the last half century.

The administration proposes to deal with the masking of the general fund deficit by creating the Social Security Integrity

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<sup>2</sup>Technically known as the federal funds deficit.

and Debt Reduction Fund. But, this proposal doesn't even start until fiscal year 1993 and is then phased in over 3 years. Even if the administration's budget forecast is correct, however, this delay will add over \$1 trillion in new debt, raising our total debt to about \$4 trillion--four times the debt at the beginning of the 1980s.

Moreover, I fear that the administration has not presented a plan that deals forthrightly with the fundamental fiscal imbalance. The Congressional Budget Office projections included in table 1 may represent a more accurate forecast of where our current policies will take us. They indicate that if we continue on our current path, the general fund deficit will actually grow to \$303 billion by 1995. In these CBO projections, the national debt rises by over \$1.5 trillion, and gross interest payments soar to \$334 billion by 1995. At that level, interest could well be the largest item in the federal budget, having surpassed defense and Social Security. In the mid-1970s, interest was only about \$30 billion.

ACCUMULATING SOCIAL SECURITY RESERVES--

AN OPPORTUNITY TO INCREASE LONG-TERM ECONOMIC GROWTH

As you know, under the current financing plan for the Social Security cash benefits programs, trust fund revenues are substantially greater than needed to meet current benefit

payments. This situation is likely to continue for about the next 40 years. Over that period, the balance in the Social Security trust fund could increase from a little more than \$160 billion today to something like \$12 trillion in 2030.

Last year, Senator Moynihan asked us to review this financing plan and to report our views about it, focusing particularly on the implications of the plan for federal budget policy and the long-run health of the economy. We gave him our analysis just about 1 year ago.

In our report, we noted that the baby boom generation will begin retiring in about 2010 and that, beginning then, the burden of supporting this nation's aged would increase significantly. Whereas today some 3.3 workers support each Social Security beneficiary, by 2030 each beneficiary will be supported by only 2 workers.

The impact of this higher burden on the welfare of tomorrow's workers depends largely on the behavior of our economy between now and then. If our economy does not grow, or grows only very little, higher future burdens can be borne by tomorrow's workers only if they are willing to accept a lower standard of living than today's workers enjoy. In contrast, if we adopt policies today that help our economy experience steady and sustained

growth over the next several decades, future workers can bear the heavier burden and still experience rising living standards.

We reported that increasing our national savings rate may be the single most important step we can take if we want to promote sustained and steady growth in future living standards. And we emphasized that the single most important step we can take today to increase national savings is to deal with our federal budget deficit.

If we were able finally to balance the federal budget, our savings rate would be significantly higher than it has been in recent years, but it would still remain low in comparison to the savings rates of many of our international competitors. In this regard, the scheduled buildup of large Social Security reserves provides us with a unique opportunity to further increase our savings rate and reduce the gap between us and our competitors. But we can take advantage of this opportunity only if we manage the rest of our budget intelligently.

In particular, the surpluses in the Social Security account will help us deal with future burdens only if they represent net additions to savings. These surpluses will not help us deal with the future if they serve merely as an excuse to avoid making other budget deficit reductions.

In our report to Senator Moynihan, we concluded that the scheduled Social Security surpluses represented an appropriate fiscal policy for the 1990s, as long as they represented a new source of national savings. We cautioned against accumulating these large Social Security reserves, however, if they merely represented an excuse for inattention to the deficit problems elsewhere in our federal budget.

#### THE ILLUSION OF CURRENT BUDGET POLICY

We share Senator Moynihan's concern that under the current Gramm-Rudman-Hollings process, the growing Social Security surpluses are serving more as a substitute for other deficit reduction actions than as a net addition to national savings. Under Gramm-Rudman-Hollings, deficit reduction is focused on the total deficit. As you know, that measure represents the combination of the Social Security surplus and the deficit in the rest of the budget. In fact, in the fiscal year just ended, the reported total deficit of \$152 billion represented the combination of a deficit of \$275 billion in the general fund, offset by surpluses of \$52 billion in Social Security and \$71 billion in all the other trust funds.

By helping us to meet the Gramm-Rudman-Hollings targets, rising Social Security surpluses are allowing us to avoid the steps necessary to make substantial progress in dealing with the



general fund deficit. Virtually all of the progress we appear to have made in dealing with our budget deficit can be traced to increasing surpluses in Social Security--and, to a lesser extent, in other trust fund accounts.

Last year we proposed restructuring the federal budget accounts to depict more clearly the various important fiscal relationships within the budget. Specifically, we recommended maintaining the unified budget concept but separating the unified budget into six constituent parts: into general, trust, and enterprise funds, with each of these subdivided to distinguish between operating and capital activities.<sup>3</sup> Such a change would provide full disclosure of the government's financial operations while retaining the discipline of presenting the combined effect of all government activities on the Treasury's cash financing needs. The government's financial results for fiscal year 1988 are presented using this format in table 2 at the end of my statement.

From a budget disclosure standpoint, the six-part budget would highlight the extent to which deficit reduction activities deal with the deficit in the general fund. As we proposed to the National Economic Commission, for example, the Gramm-Rudman-Hollings targets could then be revised to focus on both the pace

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<sup>3</sup>Managing the Cost of Government: Proposals for Reforming Federal Budgeting Practices (GAO/AFMD-90-1, Oct. 1989).

at which the budget is to be balanced and the extent to which the proper balance is stuck between current consumption and capital investment. This should help us make the tough choices necessary to bring the general fund deficit under control.

We are pleased that the Office of Management and Budget acknowledges the merit of an alternative budget presentation such as this. While not the official presentation, this year's budget submission shows how the fiscal year 1991 budget estimates look when displayed in our six-part format.

#### ENDING THE ILLUSION

As long as the rising Social Security surplus allows us to avoid dealing with the general fund deficit, we are not taking full advantage of the potential to add to national savings. If we do not use the accumulating Social Security reserves to increase our national savings rate, we will be in no better position to meet our obligations to future retirees than we would be if we had remained under pay-as-you-go financing and were forced to reduce the general fund deficit through other means.

The current Social Security financing plan requires workers to pay a higher payroll tax than would be necessary under a pay-as-you-go system. They are left with the impression that this tax is being used to build reserves to help pay for their future

benefits. We urge the Congress to take the steps necessary to ensure that this reserve accumulation has real economic meaning.

If such steps are not taken, we are using this revenue to finance other general fund expenditures--expenditures that we seem to be unwilling to ask taxpayers to pay for explicitly. In this case, the growing reserve is merely an illusion.

We must end this illusion. We must restore honesty to the budget debate. We must deal forthrightly with our fiscal imbalances. We must face the facts.

As I noted earlier, the CBO baseline projects an increase of \$1.5 trillion in our national debt by 1995. Simply returning to pay-as-you-go involves potential revenue losses of about \$60 billion a year. We would be very concerned if such a change were made in the absence of additional and offsetting spending reductions or revenue increases. Without these additional actions, we could add another \$300 billion to this growing debt burden, running the total up close to \$5 trillion.

Unless the deficit problem is solved, it will hamstring the government's ability to achieve vital policy goals; it will make it very difficult to begin addressing the nation's unmet needs; and it could sap our long-run economic vitality.

To solve our fiscal imbalance, our political leadership needs to negotiate a multiyear, politically sustainable budget strategy. We hope that Senator Moynihan's proposal will provide the catalyst to compel action.

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This concludes my statement, Mr. Chairman. I would be happy to answer any questions you might have.

**Table 1: Masking the Federal Deficits  
With Trust Funds**

Billions of Dollars	Actual FY 1985	Actual FY 1986	Actual FY 1989	Estimate FY 1990	Estimate FY 1991	Estimate FY 1993	Estimate FY 1995
Revenues	734	769	991	1,067	1,137	1,277	1,438
Outlays	946	990	1,143	1,205	1,275	1,418	1,555
<b>Total Deficit</b>	-212	-221	-152	-138	-138	-141	-118
Federal Funds Deficit	-267	-283	-275	-270	-273	-297	-303
Trust Fund Surpluses:							
Social Security	9	17	52	66	74	98	128
Other Trust Funds	45	45	71	66	62	59	57
Subtotal, Trust Fund Surpluses	54	62	123	132	136	157	185
<b>Total Deficit</b>	-212	-221	-152	-138	-138	-141	-118

**Source:** FY 1985 and 1986--OMB's Special Analysis for FY 1987 and 1988  
 FY 1989--OMB's Budget for FY 1991  
 Other Years--CBO's Economic and Budget Outlook, January 1990

**Note:** Totals may not add due to rounding

Table 2: Fiscal Year 1988 Budget Results  
Restructured According to GAO Proposal

Dollars in billions

	<u>Total</u>	<u>General</u>	<u>Trust</u>	<u>Enterprise</u>
Operating surplus/deficit(-)	\$-131	\$-248	\$124	\$ -7
Capital financing requirements	<u>-24</u>	<u>-23</u>	<u>2</u>	<u>-3</u>
Unified budget financing requirements	<u>\$-155</u>	<u>\$-271</u>	<u>\$126</u>	<u>\$-10</u>

NOTE: With the exception of the \$155 billion total, the amounts are approximations.