Statement of
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before the
Subcommittee on Retirement Income
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Select Committee on Aging
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Wednesday, February 28, 1990.

Mr. Chairman, I am pleased to be here today to discuss the budgetary and economic implications of proposals to exempt Social Security finances from the Balanced Budget Act's deficit calculations and of S. 2016, Senator Moynihan's bill to return Social Security to a pay-as-you-go-system. This statement tries to clarify a number of the issues underlying what has been a spirited, but somewhat confused, debate about the merits of alternative approaches to financing Social Security. It examines the following four issues:

- How current budget policy can enhance the nation's ability and willingness to support the increased costs of future Social Security benefits;
- The likely effects of S. 2016 on the economy;
- The impact of payroll tax reductions on the distribution of after-tax incomes of families; and
- The choice between pay-as-you-go and partial reserve financing of Social Security.

In the United States today, there are 3.3 members of the labor force for every retiree. This relationship remains roughly constant for the next 20 years. Then, between 2010 and 2030, the ratio declines sharply to about two workers for each retiree, and declines slightly thereafter (under the Social Security actuaries' intermediate assumptions). The problem, then, is how the government can help the nation adjust to a rapidly aging population, especially in the transition period starting 20 years from now when the baby boom begins to retire.

Just as the baby boomers caused sharp changes in our schools in the 1950s, in our colleges in the 1960s, and in the labor and housing markets over the last 20 years, it seems guaranteed that they will bring about important changes when they retire. Assets that have been built up in corporate pension funds and, in all likelihood, in home equity will have to be liquidated to support the consumption needs of the retirees. Barring a medical revolution, demands on the health sector and on long-term care facilities will sharply accelerate. The growing pressure on slow-growing U.S. productive capacity could spill over to heightened demands for imports. Major segments of the labor market will tighten as waves of

older workers leave the labor force, replaced by the less experienced grandchildren of the baby boom.

The real challenges to the economy in the next century extend well beyond the Social Security system. I offer these observations as a backdrop for my discussion of Social Security to emphasize that we are talking about how society will extract a sharply increasing share of the fruits of production in the future and allocate them to an enlarged retired population. Federal provision of Social Security is only a part of this landscape and, in some ways, it is one of the most tractable.

Social Security and Saving

When the baby-boom generation begins retiring, the federal government will have to transfer more resources to the retirees to whom it has made a promise of payments. To do this, the government must gain command over the resources then available. Without reducing other spending, there is essentially only one way to do this: by enhanced revenues, or "higher taxes" as we used to call them. This need is inescapable: it follows from the discrete demographic upturn in retirees and the

society has made to them. But how does government activity today have a bearing on the prospects for a transfer of resources 20 years ahead?

The only links between today's policies and the payment of tomorrow's retirement benefits are the effects of our current actions on the future size of the economy. The nation will be better able to bear increased taxes (or, a shift in the pattern of public spending) if overall gross national product (GNP) and national wealth--held in both domestic and foreign assets--are as large as possible.

The primary way for the government to enlarge the size of the economy in the future is to take actions that add to national saving--in other words, to reduce its deficit. Reducing the federal deficit will increase national saving during the 20 or so years that remain before the baby boom begins to retire. Added saving will increase the productivity of the economy and the amount of income that will be available to be shared between future workers and retirees. These improvements should make the reallocation of resources to retirees less of a strain on the working population of that time.

The reason for this amelioration is not that the share of GNP required for Social Security benefits will be drastically reduced if GNP growth is spurred. The share will be only a bit smaller because the same forces that work to increase the productivity of the economy will also generate higher wages, which in turn will result in increased Social Security benefits. As a result, the part of GNP that goes to Social Security beneficiaries will grow almost as fast as GNP as a whole will. But presumably a society with more income is better able to devote a fixed share of its resources to retirement benefits than one that is not so well off. Moreover, without question, higher wealth would make it easier to finance Medicare benefits, which are not linked to the pace of GNP growth.

This argument suggests that reduced budget deficits will increase the nation's future ability to finance retirement benefits. But they may also affect its willingness to do so because lower deficits now will reduce the share of future tax revenues that will go to pay the federal government's interest costs. If deficits are cut, the federal government's interest payments in the next century will be reduced. Consequently, more government resources could be devoted to purposes that directly benefit future citizens and taxpayers. Hence,

they may be more willing to reallocate resources to retirees than would a population that had to devote a significant portion of its tax payments to paying the debt-service costs of government services that had been consumed--but not paid for--by previous generations.

Appropriate and Inappropriate Uses of Social Security Reserves

Reducing the deficit means exactly what it says: reducing government spending or raising taxes. But not all spending and not all kinds of taxes have the same implications for national saving. It would not help national growth to gut public investment or to raise taxes in a way that discourages productive private investment. This qualification aside, the total federal deficit was designed to measure just the right thing: when it increases, the government is absorbing more saving; when it is cut, the government is absorbing less saving.

Nonetheless, this concept of the total deficit has recently been called into question by those who feel that including Social Security surpluses in it deludes the body politic. They speak of Social Security "masking the deficit" or hiding the "true deficit." They argue

that sharper reductions in the federal deficit would have been more likely had the Social Security surplus not helped to obscure the lack of change in the deficit in all other federal accounts combined since 1983. They contend that the practice of investing Social Security reserves in Treasury securities is an illegitimate use of these resources to finance other activities of government.

This line of argument is faulty on several grounds. First, we do not know how fast the deficit in the rest of the federal budget would have declined without the growing Social Security surpluses of the 1980s. When the Balanced Budget Act's targets for the deficit were set, it was well known that Social Security would generate large surpluses. Had those surpluses not been a prospect, the targets in all likelihood would have been set higher. If they had not been, the gap between the targets and the actual deficits probably would have been commensurately larger. The reason the deficit has not been cut by more is not that the deficit targets were insufficiently ambitious. Rather it was that the steps needed to bring the deficit down were too painful and that there existed little leadership or public support for such actions.

Moreover, it is difficult to make a case that the Social Security surplus has been hiding the deficit in the remainder of the budget since the Balanced Budget Act was passed in 1985. The Balanced Budget Act took Social Security **off-budget** precisely to highlight its importance to the overall deficit. Both CBO and OMB began explicitly showing figures on the Social Security surplus and the deficit in the rest of the budget in early 1986, and they have continued to do so ever since. The budget resolutions adopted by the Congress for the **fiscal** years following 1986 clearly indicated the size of the expected Social Security surplus and the projected deficit in the balance of the budget. If policymakers have chosen not to reduce the deficit in the non-Social Security budget more during that period, it has not been because that deficit has been hidden from view.

In addition, the Social Security surplus is not an accurate measure of Social **Security's** offsetting effects on federal borrowing. A significant component of the surplus is made up of transfers from other federal accounts. These transfers work to increase the apparent size of both the Social Security surplus and the non-Social Security deficit, as is shown in Table 1. In other words, the amount of surplus that the Social Security trust fund is generating independently of the

TABLE 1. SOCIAL SECURITY INCOME AND OUTLAYS
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Income						
Income from Public:						
Off-Budget Revenues	288	309	330	352	376	401
Intrabudgetary Income:						
Interest	16	22	27	34	42	50
Employer share of employee retirement	6	6	7	7	8	9
Taxes on benefits	4	5	5	6	6	7
Other	2	a	a	a	a	a
Subtotal	28	32	39	47	56	66
Total Income	316	341	369	399	432	467
Outlays						
Payments to Public:						
Benefit payments	243	260	277	294	312	331
Administrative expenses	2	2	2	2	3	3
Subtotal	245	262	279	297	315	334
Intrabudgetary Payments[b]	4	4	5	5	5	5
Total Outlays	250	267	284	301	320	339
Surplus						
As Conventionally Measured		74	85	98	112	128
Less: Intrabudgetary Transfers (Net)	-24	-28	-35	-42	-51	-61
Surplus Excluding Intrabudgetary Transfers	42	47	51	56	61	67

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Primarily interest paid to Treasury on normalized tax transfers and payment to Railroad Retirement.

rest of the government is less than it appears and, similarly, the size of the deficit that the non-Social Security budget is running independently of Social Security is less than it appears.

Finally, the notion that lending Social Security reserves to the Treasury represents a misuse of those funds reflects a misunderstanding of earmarked revenues in the federal budget. First, Social Security contributions eventually will be used for Social Security benefits; every dollar coming in results in budget authority for the Social Security trust fund. Second, the U.S. Treasury always uses whatever cash is on hand to make payments before borrowing. Thus, when any fund shows a surplus, the excess cash is used to meet the Treasury's current obligations, whether the excess cash comes from Social Security contributions, gasoline taxes, or taxes on recreational fishing gear. In that sense, the money is used for nonearmarked purposes. There is no sensible alternative to this procedure: after all, why should the Treasury borrow funds when it already has them?

Third, strictly speaking, the only way to avoid devoting earmarked receipts to other purposes is for the Treasury to have no need to spend any excess funds

derived from the earmarked accounts. This means not only balancing the overall budget, but running a surplus. In other words, what some consider to be ill-advised uses of Social Security reserves will end only when the government eliminates the deficit and contributes to national saving rather than using it up. But the case for the government's budget to be in surplus surely should be argued on the merits of its effects on national saving, not on a desire to avoid the appearance of misusing earmarked funds.

So far, I have tried to show why the currently fashionable view that only the non-Social Security deficit can be viewed as the "true" federal deficit is incorrect. The best measure of the extent to which the federal government absorbs private saving remains the deficit of the whole federal government (other than for federal investments), including Social Security.

ECONOMIC IMPLICATIONS OF S. 2016

On January 23, Senator Daniel P. Moynihan introduced S. 2016. In the subsequent debate, the effects of this bill on the economy and on the distribution of income have played a major role. What would enactment of S. 2016 do

to the economy? If the measure were enacted without offsetting reductions in the deficit, it could have adverse economic effects over both the short and long run. CBO has estimated that S. 2016 would increase the $138 billion baseline deficit by $40 billion in 1991 and by greater amounts in later years (see Table 2). This figure is slightly lower than other estimates, partly because it incorporates an assumption that wage rates would increase somewhat in response to the reduction in the employers' payroll tax rate, thereby raising other tax revenues enough to offset a part of the direct revenue loss.

Short-Run Effects

Because the economy is operating close to its full capacity now, a significant reduction in payroll tax rates without offsetting deficit reductions elsewhere could harm the economy's performance over the next several years. A significant payroll tax cut could increase total demand for goods beyond the economy's capacity to produce them, leading potentially to increases in both inflation and the trade deficit. The Federal Reserve would be likely to try to head off such extra inflation by raising interest rates, which are

TABLE 2. BUDGETARY EFFECT OF S. 2016
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Off-Budget (Social Security)						
Baseline Surplus	66	74	85	98	112	128
Changes:						
Payroll taxes	-5	-42	-58	-62	-67	-71
Interest	a	-2	-6	-11	-17	-23
Total changes	-5	-45	-64	-74	-84	-94
Surplus, S. 2016	61	30	21	24	29	34
Off-Budget (All Other)						
Baseline Deficit	-204	-212	-221	-239	-242	-246
Changes:						
Income tax offset[b]	1	4	6	6	7	7
FERS offset[c]	a	a	a	1	1	1
Interest	a	a	1	1	2	2
Total changes	1	5	7	8	9	10
Deficit, S. 2016	-204	-208	-214	-231	-233	-235
Total Budget						
Baseline Deficit	-138	-138	-135	-141	-130	-118
Changes:						
Payroll taxes	-5	-42	-58	-62	-67	-71
Income tax offset[b]	1	4	6	6	7	7
FERS offset[c]	a	a	a	1	1	1
Interest	a	-2	-6	-10	-10	-20
Total changes	-4	-40	-58	-66	-75	-84
Deficit, S. 2016	-143	-178	-193	-207	-204	-202

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Assuming that nominal GNP is held constant, a reduction in Social Security taxes would increase income and, therefore, increase income taxes. These estimates are net of increased income tax revenues.

c. A reduction in Social Security taxes would automatically increase the tax rate for the Federal Employees Retirement System.

already quite high by historical standards when adjusted for inflation. These higher rates could further reduce investment and complicate many problem areas, such as the cash-flow problems of developing countries and domestic corporations that are already heavily indebted. In addition, they could make resolving the currently formidable problems of the thrift industry even more difficult.

Long-Term Effects

Over the long run, significant increases in the federal deficit could exacerbate several current economic problems, such as low net investment, slow growth in productivity, and faltering competitiveness in international markets. A further increase in the federal deficit from a cut in taxes would divert more of our limited saving away from investment (including research and development) that could increase our productivity, competitiveness, and living standards. Competitiveness would also suffer if the higher interest rates that would accompany lower saving caused the dollar to appreciate on foreign exchange markets, making American goods more expensive and foreign goods cheaper.

Some analysts have argued that reduced payroll tax rates for employers could help improve the competitiveness of American goods by reducing this component of labor costs. This outcome, though, seems unlikely. Most studies of the payroll tax conclude that the employers' share ultimately has little effect on employers' costs because it is absorbed by workers in the form of lower wages than they would otherwise get. This implies that a reduction in employers' rates would be met with offsetting increases in wage rates or additional fringe benefits. As a result, there might be little improvement in the costs of employers, and therefore in the competitiveness of the goods that they produce.

Effects on the Income Distribution

A major impetus behind the current effort to reduce the. payroll tax is the recent trends evident in the distribution of income and the progressivity of the tax system. Between 1980 and 1990, average adjusted real family income--family income divided by the appropriate poverty threshold--of the top fifth of families rose by 31.7 percent, while the average income of families in the bottom four income quintiles either rose much more slowly or actually declined as in the case of the bottom income

quintile (see Table 3). During this same period, the total federal effective tax rate of families in the top two income quintiles declined, while in the bottom three quintiles it rose (see Table 4). Although federal taxes in 1990 are more progressive than they were in 1985, they are less progressive than they were in either 1977 or 1980.

The increased reliance on social insurance payroll taxes is the major explanation for the reduced progressivity of the tax system. Lowering payroll tax rates over the next 25 years with no offsetting changes

TABLE 3. AVERAGE ADJUSTED FAMILY INCOME
(Income expressed as multiples of the poverty thresholds)

Quintile[a]	1977	1980	1985	1990[b]	Percentage Change 1977-1990	1980-1990	1985-1990
Lowest[c]	0.95	0.86	0.80	0.84	-11.8	-3.2	4.5
Second	2.06	1.92	1.86	2.00	-2.7	4.3	7.3
Third	3.09	2.93	2.96	3.18	2.8	8.4	7.2
Fourth	4.34	4.17	4.35	4.70	8.4	12.6	8.0
Highest	8.70	8.61	9.83	11.34	30.3	31.7	15.3
Top 10 percent	11.46	11.39	13.39	15.76	37.6	38.4	17.7
Top 5 percent	15.22	15.42	18.65	22.52	48.0	46.1	20.8
Total[d]	3.84	3.69	3.96	4.39	14.3	18.7	10.8

SOURCE: Congressional Budget Office Tax Simulation Model.

a. Ranked by size of adjusted family income.
b. Projected based on Internal Revenue Service and Census Bureau data, using CBO economic forecast.
c. Excludes families with zero or negative incomes.
d. Includes families with zero or negative incomes not shown separately.

in other federal spending or taxes would ameliorate this situation somewhat. If the Balanced Budget Act deficit targets were adhered to, however, offsetting changes in spending or taxes would be required. Whether the end result would be to make federal taxes more or less progressive or the distribution of income more or less equal would depend on the nature of these offsetting measures. Among the many possible offsets to the deficit-increasing effects of a payroll tax cut, I will discuss two in my statement today--an increase in income

TABLE 4. TOTAL FEDERAL EFFECTIVE TAX RATES

Quintile[a]	1977	1980	1985	1990[b]	Percentage Change 1977-1990	Percentage Change 1980-1990	Percentage Change 1985-1990
Lowest[c]	9.5	8.4	10.6	9.7	2.6	16.1	-8.1
Second	15.6	15.7	16.1	16.7	6.6	6.0	3.8
Third	19.6	20.0	19.3	20.3	3.6	1.2	5.1
Fourth	21.9	23.0	21.7	22.5	2.6	-2.2	3.6
Highest	27.1	27.3	24.0	25.8	-4.6	-5.5	7.4
Top 10 percent	28.7	28.4	24.4	26.4	-8.1	-7.3	8.2
Top 5 percent	30.5	29.5	24.5	26.7	-12.5	-9.5	9.0
Total[d]	22.8	23.3	21.7	23.0	1.2	-1.0	5.9

SOURCE: Congressional Budget Office Tax Simulation Model.

a. Ranked by size of adjusted family income.

b. Projected based on Internal Revenue Service and Census Bureau data, using CBO economic forecast.

c. Excludes families with zero or negative incomes.

d. Includes families with zero or negative incomes not shown separately.

tax rates and the imposition of a federal value-added (sales) tax (VAT).

Effects on the Distribution of After-Tax Incomes

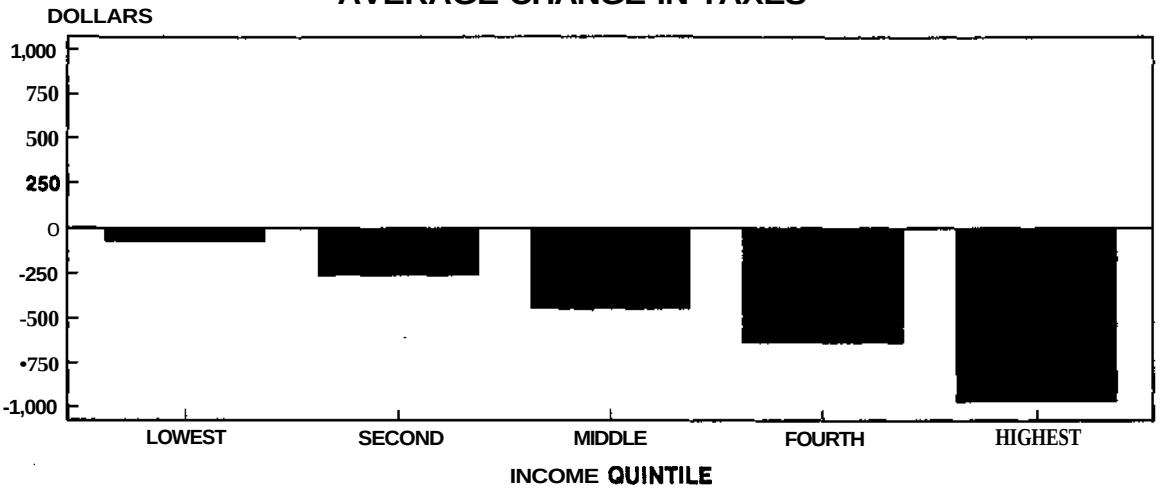
Lowering payroll taxes would not appreciably increase the relative share of after-tax income received by low-income families. If payroll taxes were reduced by $50 billion and not offset by increases in other taxes, the tax burdens--federal taxes as a percent of pre-tax incomes--on lower-income families would be reduced relatively more than those of middle- and upper-income families (see Figure 1). The payroll tax reductions would raise the after-tax incomes of families in the lowest income quintile by 1.1 percent and the after-tax income of families in the highest income quintile by 1.2 percent. These results reflect the assumption that the employers' share of payroll taxes is ultimately paid by workers in the form of lower wages.

Offsetting Increases in Income-Tax Rates

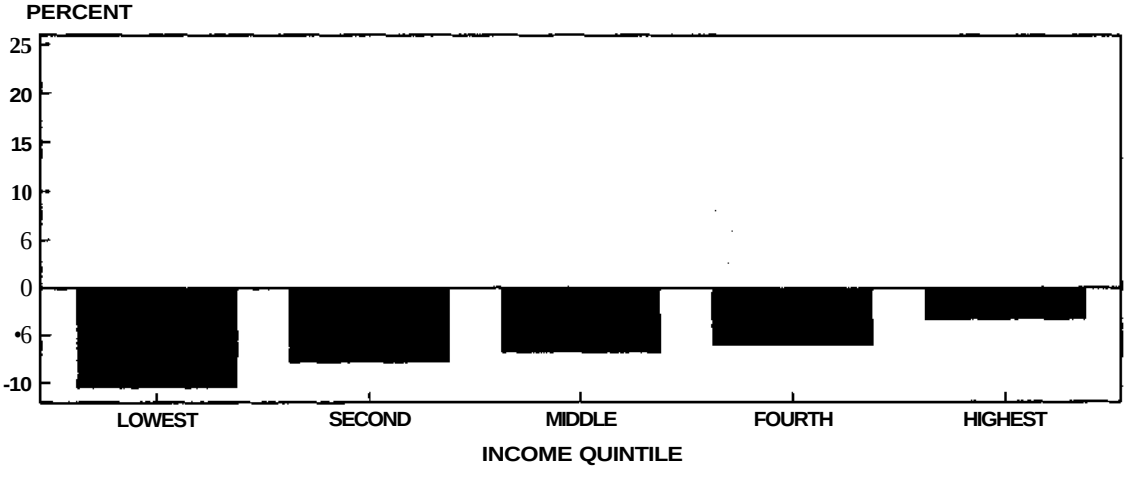
If the $50 billion in lost revenue from the payroll tax were replaced through a surcharge of about 10 percent on

FIGURE 1. S. 2016

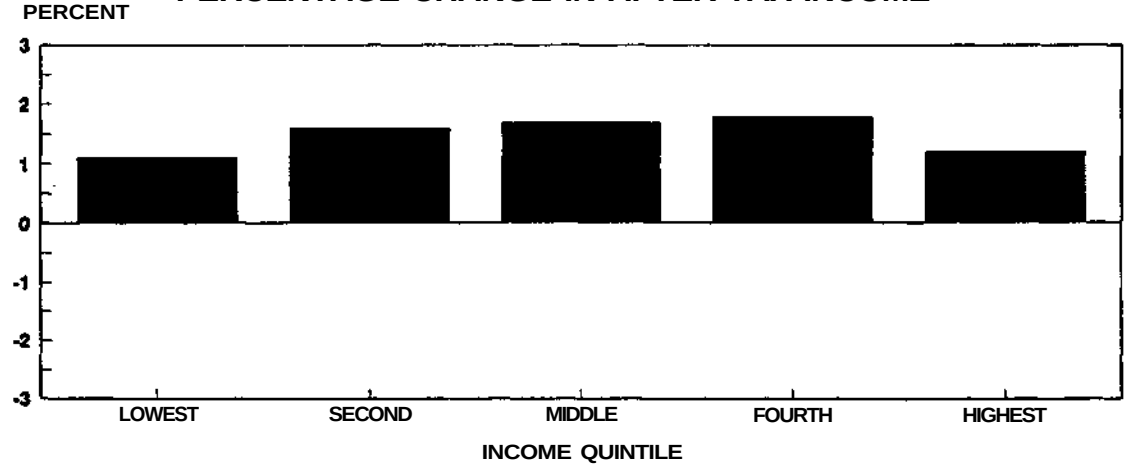
AVERAGE CHANGE IN TAXES



PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES



PERCENTAGE CHANGE IN AFTER-TAX INCOME



SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

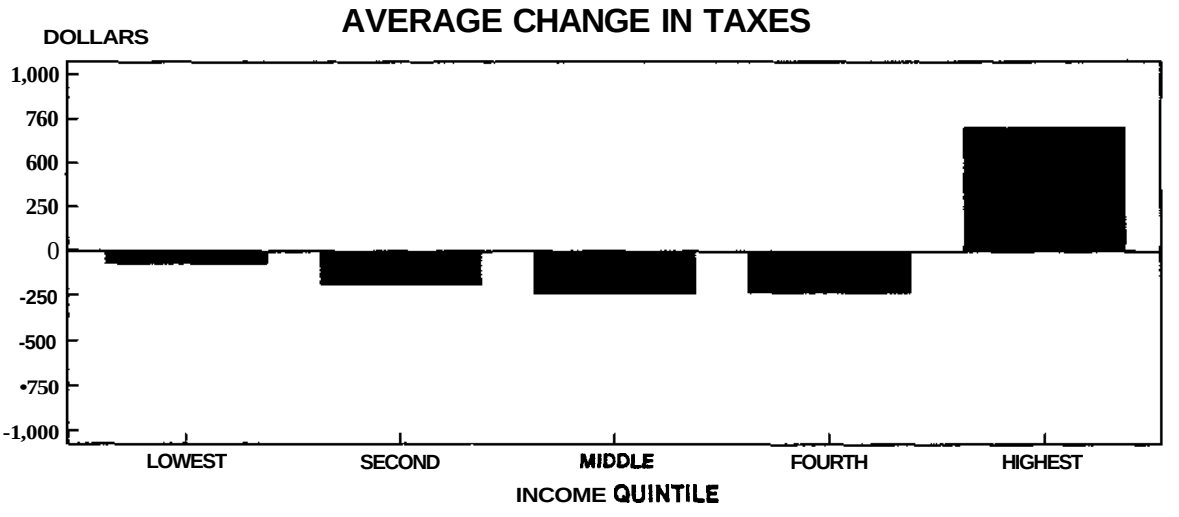
individual income taxes, the U.S. tax system would be more progressive (see Figure 2). About four-fifths of taxpayers would receive net cuts in taxes paid. The relative change in after-tax incomes would range from a 1 percent increase among families in the bottom quintile to a 0.9 percent decrease among families in the top quintile.

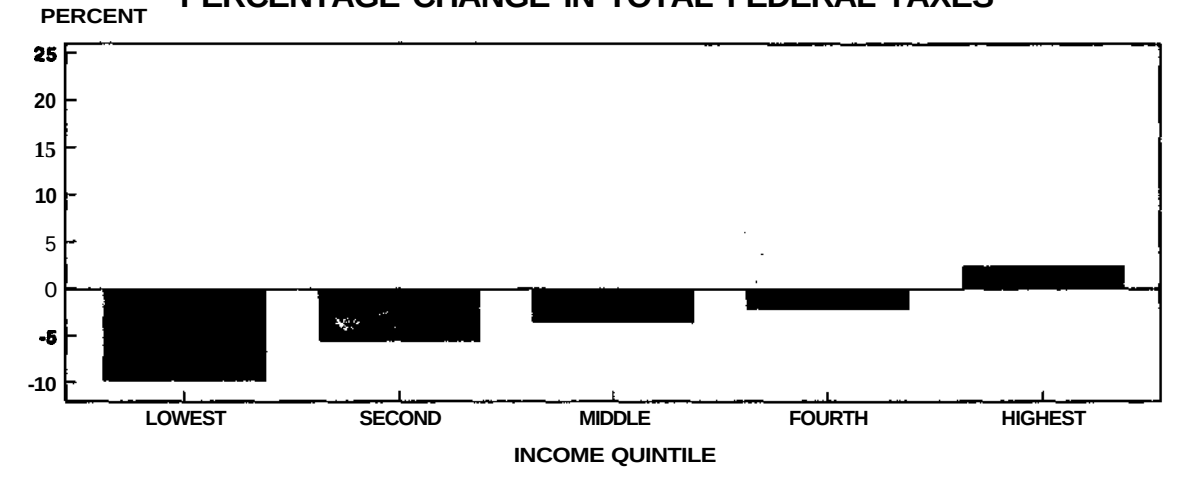
Replacing payroll taxes with income taxes would also change the distribution of taxes paid among different types of taxpaying households. The high-income elderly, most of whom do not pay Social Security taxes, would be more likely to pay higher net taxes than younger taxpayers. For example, elderly families in the one-fifth of the population with the highest incomes would face an average net decrease in after-tax income of 1.5 percent compared with a net decrease of 0.9 percent for all families in the top quintile.

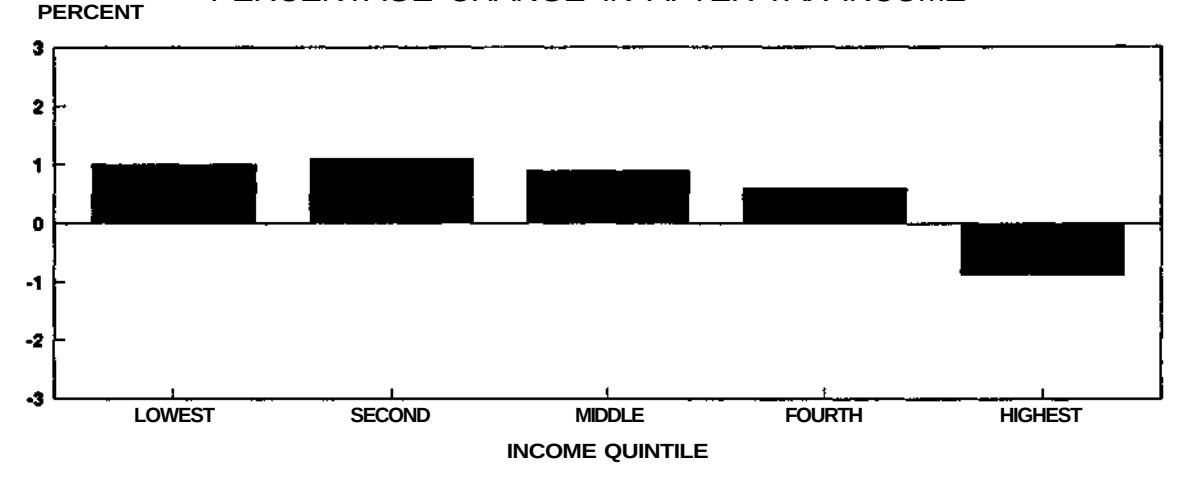
Effects of Imposing a Federal Value-Added Tax

If the revenue lost from lowering payroll tax rates were made up by imposing a value-added tax, it would make the

FIGURE 2. S. 2016 WITH OFFSETTING INCOME TAX SURCHARGE







SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

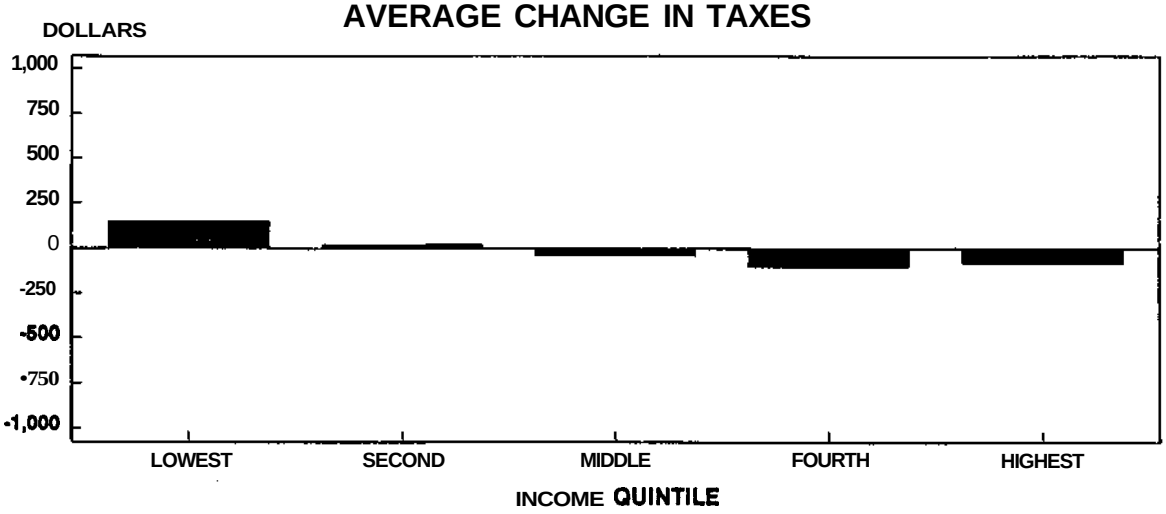
tax system less progressive, as shown in Figure 3.[1] The one-fifth of families with the lowest annual incomes would face the largest net increase in taxes. Many of these households spend more than their annual income by borrowing or by selling assets, as for example would be likely among the elderly. Households in such circumstances would pay relatively little in payroll taxes, and thus would receive little or no tax relief from lowering such taxes, but they would pay value-added taxes on their purchased consumption. Replacing payroll taxes with a VAT would be regressive, with effects ranging from a 2.0 percent decrease in after-tax incomes among the one-fifth of taxpayers with the lowest incomes to a 0.1 percent increase among taxpayers in the highest income quintile.

While replacing payroll taxes with a VAT would make the present tax system less progressive, let me note that these measures overstate the increase in regressivity because a portion of families with low incomes in a particular year are not needy by other standards. Some households, for example, are able to sell assets to pay

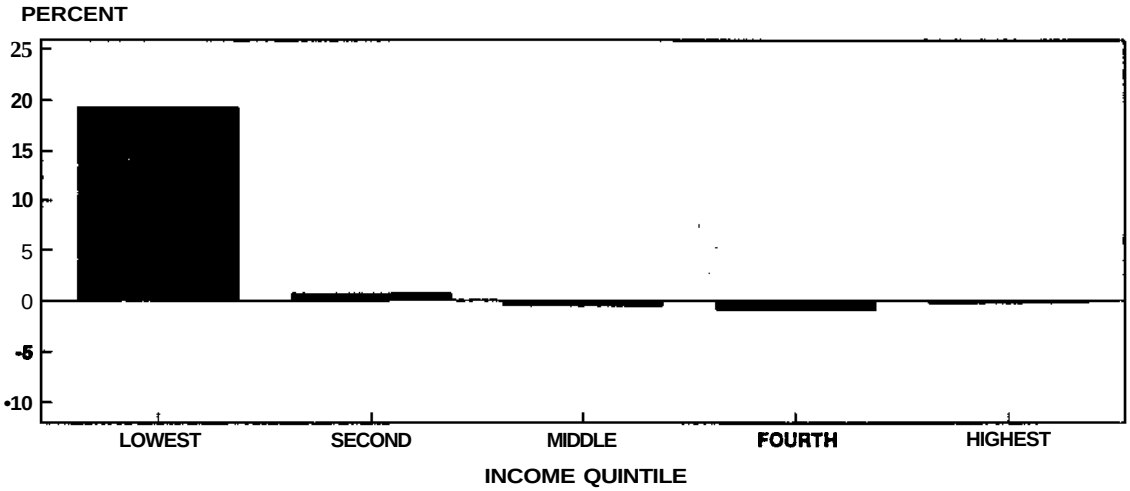
1. The simulations are for a VAT that excludes food purchased for home consumption, housing expenditures (including utilities), medical care, educational expenditures, and contributions to religious and charitable organizations. This VAT is similar to that proposed by Senator Hollings as a replacement for lower payroll taxes.

FIGURE 3. S. 2016 WITH OFFSETTING VALUE-ADDED TAX

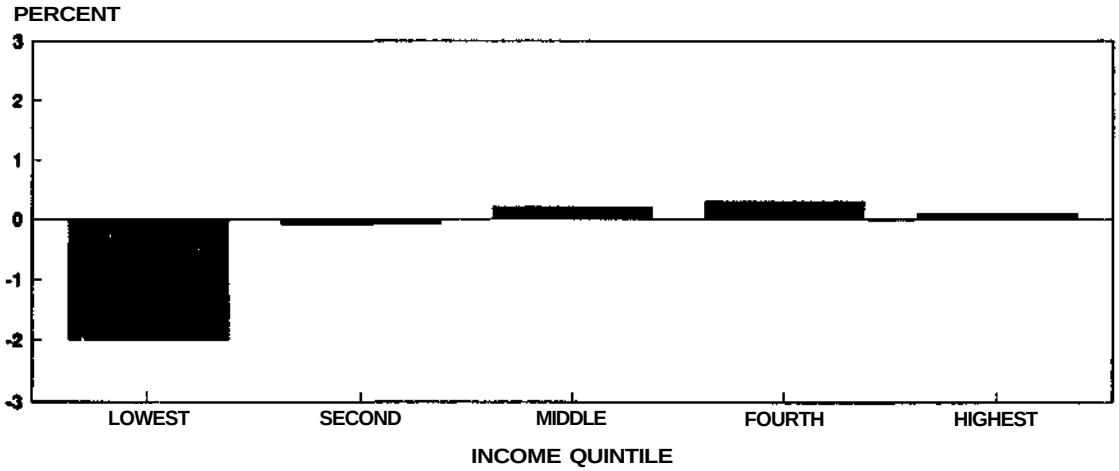
AVERAGE CHANGE IN TAXES



PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES



PERCENTAGE CHANGE IN AFTER-TAX INCOME



SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

for spending that exceeds income. Value-added taxes would take up a larger share of the income of such households than it would of households that finance spending entirely from their annual income. In this case, value-added taxes would appear regressive, even though some families able to pay for spending out of existing wealth may not be needy.

Other Alternatives

Reduced payroll taxes could be offset in many more ways than the two examples discussed above. Some people have suggested that higher gasoline taxes should be considered. A detailed discussion of this alternative is not included in this statement largely because it could have far-reaching effects on the economy, which would require considerable analysis. In order to raise $50 billion in net revenue, it would be necessary to raise the gasoline tax by about 50 cents a gallon--an increase that is beyond the realm of U.S. historical experience. Preliminary simulations of the distributional effects of replacing $50 billion in payroll taxes with higher gasoline taxes, however, suggest that this alternative would be even more regressive than a VAT.

IMPLICATIONS OF S. 2016 FOR SOCIAL SECURITY FINANCING

The previous discussion of the overall economic, budgetary, and distributional implications of S. 2016 does not address the more narrow but equally important issue of how the nation should finance Social Security benefits. S. 2016 has rekindled an old debate on Social Security financing. Should payroll tax rates be set so as to produce annual revenues approximately equal to annual outlays (in other words, pay-as-you-go financing)? Or should a reserve be built up (in other words, partial reserve financing), thereby establishing substantial interest earnings as an important source of financing?

Until 1972, tax rates were scheduled so that significant trust fund buildups would develop in the long run without subsequent legislative action. These substantial reserves never materialized, primarily because benefits were increased sufficiently to absorb the reserves before they could build up. As a result, the program was run on a de facto, pay-as-you-go basis during the 1951-1972 period. The Social Security Amendments of 1972, which indexed benefits to inflation, effectively legislated the pay-as-you-go structure. Five years later, the 1977 amendments reversed course and restored a significant trust fund buildup over the 1980-

2010 period by moving a scheduled payroll tax increase from 2011 to 1990. For the first time, however, long-range financing was not sufficient to meet anticipated program costs for the next 75 years, and the trust fund buildup was to be dissipated by 2030. This pattern of trust fund buildup and subsequent depletion (now projected to occur in 2046) was magnified by the Social Security Amendments of 1983.

The Case for Partial Funding

Two principal cases are made for building up a large, payroll-tax financed accumulation in advance of the baby boom's retirement. One case is based on providing greater equity between the baby-boom generation and those that follow them. The other is an explicitly political argument relating to the difficulty of enforcing a surplus in the total federal budget.

The Issue of **Equity.** If each succeeding generation of Americans is of approximately equal size, pay-as-you-go financing raises no particular intergenerational equity issues. The payroll tax rate for each generation of workers can be held roughly constant and still satisfy

the benefits promised to each generation of retirees. Indeed, later generations of retirees can receive higher real retirement benefits than their predecessors, even if the number of retirees grows somewhat over time, as long as real growth in productivity holds up.

But if, as is the case for the baby-boom generation, there is a discrete jump in the size of one generational group, pay-as-you go financing raises an issue of equity. The baby-boom cohort is able to pay a low payroll tax while working, because there are so many of them paying for a small preceding generation. When the large cohort retires, however, their successors (the groups born since the 1960s) will have to bear a higher payroll tax rate. Given these demographics, advocates of advance accumulation would maintain the current payroll rate, which is above the amount needed for pay-as-you-go financing for the next 20 years. This increase, they contend, would guarantee that the baby-boom generation bears its fair share of the burden and does not stick the succeeding generations with a big, undeserved bill. (Beyond the 20 year mark, payroll rates would again have to be raised to reach a long-term sustainable level, adequate to pay for the projected higher ratio of retirees to workers.)

The Issue of Budget Surpluses. If the only way to raise national savings over the next 20 years is for the government to run large surpluses in its overall budget, doing this outside the Social Security accounts may be politically impossible. To achieve these surpluses with the Social Security accounts held to a balance (as is implied by pay-as-you-go financing) means that the rest of the budget must run a surplus. But today, the rest of the budget is miles from even being balanced, let alone running a surplus. Moreover, the rationale for running surpluses in these non-Social Security accounts has never been sold to the electorate.

In response, the proponents of Social Security accumulation say that the only way to achieve an overall surplus is to aim for a balanced non-Social Security budget (a concept the public has consistently endorsed) accompanied by a Social Security surplus (the public understands the concept of saving for retirement, and the Social Security surplus is already embodied in current law). The Administration's proposed Social Security Integrity and Debt Reduction Fund, I would note parenthetically, seems similarly motivated, as do many of the plans calling for an off-budget treatment of Social Security.

The Case for Pay-As-You-Go Financing

In a practical sense, pay-as-you-go financing (under which rubric I would also include plans for accumulating modest reserves to provide protection against the adverse consequences of recessions) has been the actual system for paying for Social Security nearly since its inception. It bears repeating that this system has worked, and it has met the highest political test: Social Security has built political support unequaled by other programs. Pay-as-you go financing helped build this support.

The Issue of Equity. Looking only at the payroll tax rate over time is too narrow a basis for viewing equity among generations. If the nation chooses to solve its admitted savings problem over the next 20 years, baby boomers will pay the price even with pay-as-you-go financing. For example, if the government imposes higher income or gasoline taxes or cuts public services any time soon, the baby boomers are precisely the ones who will bear the brunt of these. If the baby boomers decide to save more privately as they mature (not an impossibility), then they will be the ones who will have to lower their current consumption. In contrast, succeeding generations are likely to enjoy higher real

wages as a result of labor shortages during the baby-boom retirement years, while baby boomers may have had poorer chances of real wage growth and career advancement during their working years. Moreover, baby boomers may not benefit *as* much as previous generations when they liquidate their assets, such as homes or thrift plan accumulations, when they retire.

Thus, broader comparisons of the relative economic positions of the baby-boom and subsequent generations suggest little need, if any, to redress inequities. That is to say, there is no reason based on equity considerations to require the baby boomers to bear unnecessarily high payroll rates in the next 20 years.

The Issue of Flexibility. Pay-as-you-go financing has an additional virtue over a rigid plan for running surpluses in Social Security, stemming from the need to keep legislative options open. In practical terms, holding to a course of Social Security buildup for the next 20 years effectively closes the books on changing that program. While in many respects precluding changes in Social Security is a desirable goal, we should always acknowledge that societal changes we cannot now foresee may make certain Social Security changes desireable as well. Consider, for example, marital arrangements,

participation in the work force, immigration, private pension accumulations, life expectancies, health status of the aged, and the changing physical demands of work: all of these have a bearing on how we structure Social Security.

Pay-as-you-go financing keeps the books open on Social Security--not for capricious, short-run fiddling, which everyone should oppose, but for periodic reexamination. By the same token, if we learn that we have got it wrong in making 75-year projections, pay-as-you-go financing will readily permit future adjustments in Social Security or elsewhere, whereas the accumulation strategy, combined with a commitment to maintain total government surpluses, may prove to be too tight a straitjacket.

Resolving the Issue of Social Security Financing

Finally, let me turn to how to resolve the issue of the proper financing plan for Social Security. Mr. Chairman, as you know, CBO does not make policy recommendations, and I will not deviate from that practice here. But a few observations are in order.

First, the issue of Social Security financing should not be regarded as having been settled by the 1983 Social Security Amendments. The issues I have raised today were not debated in full at that time, and they deserve to be debated before the issue can be considered resolved. Second, it is clear that no substantial policy change in Social Security can be meaningfully decided in isolation. I have already pointed out the links of Social Security to overall national saving and budget policies. I would also add now its obvious link with health care programs for the aged. It is unthinkable to change the payroll tax based on considerations of retirement benefits alone when we know that the Medicare trust funds will be in trouble, probably even before the baby boomers retire. Finally, since the trust fund buildup in the next couple of years is warranted just to offer protection against a recession, there is little need to resolve the Social Security financing issue right away.

CONCLUSION

Social Security is woven deeply into the fabric of American society. The program affects roughly 133 million workers and more than 39 million beneficiaries, with its payroll taxes accounting for more than one-

quarter of total federal revenues and its benefits constituting one-fifth of total federal expenditures. Nearly two out of every five workers find their own FICA payments exceeding their income tax liabilities, and about three-quarters face combined employee/employer payroll taxes that are greater than their income taxes. More than one-half of aged Social Security recipients depend on these benefits for the major share of their total income. Moreover, millions of other family members receive insurance protection against income lost with the retirement, disability, or death of a worker. These statistics highlight that any program changes, whether they alter benefit payments or the way the program is financed, deserve much careful study and debate.

Large federal deficits combined with relatively low U.S. savings rates jeopardize the future growth in the standard of living for Americans. Without significant economic growth, future taxpayers may be both less willing and less able to support existing federal commitments, including those for Social Security and Medicare. Therefore, S. 2016 raises the issues of not only how we structure our taxes to finance Social Security, but also what our overall commitments should be to savings, investment, and economic growth.