

The Social Security Surplus— A Solution to the Federal Budget Deficit?

By C. Alan Garner

Throughout the 1980s, fiscal policymakers have grappled with a large and persistent federal budget deficit. Although some progress has been made in reducing the deficit, cutting government spending and increasing tax revenues have proved to be politically difficult. As a result, other possible solutions to the federal deficit are being considered. In particular, a great deal of attention has been paid recently to using the social security system to finance the deficit. The social security program is currently running a substantial surplus that is projected to grow even larger in the years ahead.

Could the growing social security surplus be

a solution to the large federal budget deficit? The social security surplus is already paying for current government spending by financing part of the deficit in the non-social security portion of the budget. Further growth of the social security surplus would permit social security to finance an even larger share of government spending. Yet social security also faces the long-run challenge of meeting the retirement needs of the baby-boom generation in the next century. Relying on the social security surplus to finance the deficit could jeopardize future retirees' standard of living.

This article examines the social security system's role in reducing the federal budget deficit. It concludes that policymakers should not rely on the social security surplus to reduce the deficit but instead should concentrate on controlling the deficit in the non-social security portion of the budget. The first section shows how the social security surplus could be

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used to reduce future budget deficits. The second section explains why a growing social security surplus is needed to provide for the retirement of the baby-boom generation. Finally, the third section argues that policymakers must control the deficit in the non-social security portion of the budget in order to increase national saving and, therefore, to provide adequately for both the baby-boom retirees and future working-age households.

Social security and the budget deficit

Many economists believe that the dramatic growth of the federal budget deficit in the 1980s has harmed the U.S. economy. According to this view, the budget deficit has raised interest rates, reduced domestic investment, and worsened the international trade deficit.¹ The

¹ In this view, the budget deficit and a decline in the household saving rate have combined with strong private credit demands to create a scarcity of domestic savings in the 1980s. This scarcity has raised interest rates and therefore discouraged private investment spending. Higher interest rates have also attracted large amounts of foreign capital into the United States. The inflow of foreign funds bid up the foreign exchange value of the dollar in the first half of the 1980s, causing the trade balance to worsen. For further discussion of the relationship between the budget deficit and the trade deficit, see Craig S. Hakkio and Bryon Higgins, "Is the United States Too Dependent on Foreign Capital?" *Economic Review*, Federal Reserve Bank of Kansas City (June 1985), pp. 23-36.

However, some economists believe the budget deficit has not had substantial effects on U.S. economic performance. According to an economic theory known as Ricardian equivalence, the budget deficit could not raise interest rates because an increase in the deficit would cause an offsetting increase in private saving. A brief discussion of this theory and related empirical work can be found in Michael J. Boskin, "Tax Policy and Economic Growth: Lessons from the 1980s," *Journal of Economic Perspectives* (Fall 1988), pp. 90-92.

American public has also been concerned about such massive deficit spending. As a result, Congress has enacted multiyear targets for reducing the budget deficit. But deficit reduction has been extremely difficult because of continued demand for government services and widespread opposition to tax increases. Thus, since the social security surplus will grow rapidly without any further action by policymakers, some policymakers may find the social security surplus an appealing solution to the deficit problem.

Social security in the federal budget

Is it sensible to view the social security surplus as a possible solution to the federal budget deficit? Yes, because in an accounting sense social security affects federal receipts and payments. Moreover, there is a strong economic rationale for including social security in the measured federal deficit.

The most widely quoted measure of the federal deficit is the total budget deficit, sometimes called the unified budget deficit. The total deficit consolidates the social security program with other federal receipts and outlays. Table 1 contains baseline projections by the Congressional Budget Office (CBO) for the total budget deficit, the social security surplus, and the deficit in the non-social security portion of the budget. Baseline projections show the consequences of leaving current budgetary policies unchanged and therefore differ from budget forecasts that might anticipate changes in federal programs.² The social security system

² As a result, the baseline projections do not incorporate the Bush Administration's budgetary proposals. The CBO

TABLE 1
Baseline budget projections and deficit targets
 (by fiscal year in billions of dollars)

	<u>1988</u> <u>Actual</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>
Social security surplus	39	56	68	79	90	103	117
Non-social security deficit	194	211	209	219	225	233	239
Total budget deficit	155	155	141	140	135	129	122
Gramm-Rudman-Hollings deficit targets	144	136	100	64	28	0	*

*The Balanced Budget Reaffirmation Act of 1987 did not establish a deficit target for 1994.
 Source: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994* (CBO, January 1989), pp. 41, 46.

had a surplus of \$39 billion in fiscal year 1988. At the same time, the federal government ran a deficit of \$194 billion in its non-social security programs. Combining the social security surplus and the deficit in the non-social security portion of the budget gives a total budget deficit of \$155 billion for fiscal year 1988.

The total budget deficit is also the measure used in the government's deficit reduction targets (see the bottom row of Table 1). The deficit targets for 1988-93 were set by the Balanced Budget Reaffirmation Act of 1987,

commonly known as the Gramm-Rudman-Hollings Act. This act set a target of balancing the federal budget in fiscal year 1993. The Gramm-Rudman-Hollings Act requires sequestration, or automatic across-the-board spending reductions, if estimates by the Office of Management and Budget indicate the total budget deficit will be more than \$10 billion above target. However, social security and certain other outlays are exempted from the sequestration process.

Social security is unlike most other components of the federal budget in that it is organized into trust funds. A federal trust fund is an accounting device to keep track of receipts and payments related to particular federal programs. Trust funds are intended to assure program participants that future payments will be made. However, such payments can never be guaranteed absolutely because Congress retains

estimates of revenues and entitlement spending are based on current laws and the CBO's economic outlook through 1994. Appropriations for discretionary spending are assumed to increase in line with projected inflation. Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994* (CBO, January 1989), pp. 38-40.

the authority to change future benefit levels or divert trust fund receipts to other purposes.

The social security system includes two federal trust funds, one for benefit payments to retirees and their survivors and another for disability benefits. In budget discussions, these trust funds are often combined under the heading of Old-Age, Survivors, and Disability Insurance (OASDI). The receipts of the OASDI funds include earmarked tax receipts, such as payroll taxes, and interest payments on Treasury securities held by the trust funds. Payments by OASDI include retirement and disability benefits and administrative expenses.³

In an accounting sense, then, social security affects the total budget deficit. But there is also an economic rationale for consolidating social security with other federal programs. When the social security system runs a surplus, the trust fund balances are invested in Treasury securities. As a result, fewer securities need to be sold to the private market. In other words, the federal government's overall borrowing requirements are reduced, and the total budget deficit thus represents the federal government's overall demand for credit. And such a broad deficit measure is generally the most useful for economic and financial analyses.

³ Other trust funds also affect the federal budget deficit. These trust funds are associated with Medicare, the retirement programs for military and civilian government employees, unemployment insurance, highway and airport construction, and various smaller programs. The Medicare program has two trust funds, Hospitalization Insurance and Supplemental Medical Insurance. The role of trust funds in the federal budget is discussed in Congressional Budget Office, *The Economic and Budget Outlook: An Update* (CBO, August 1988), pp. 58-61.

The outlook for the social security surplus

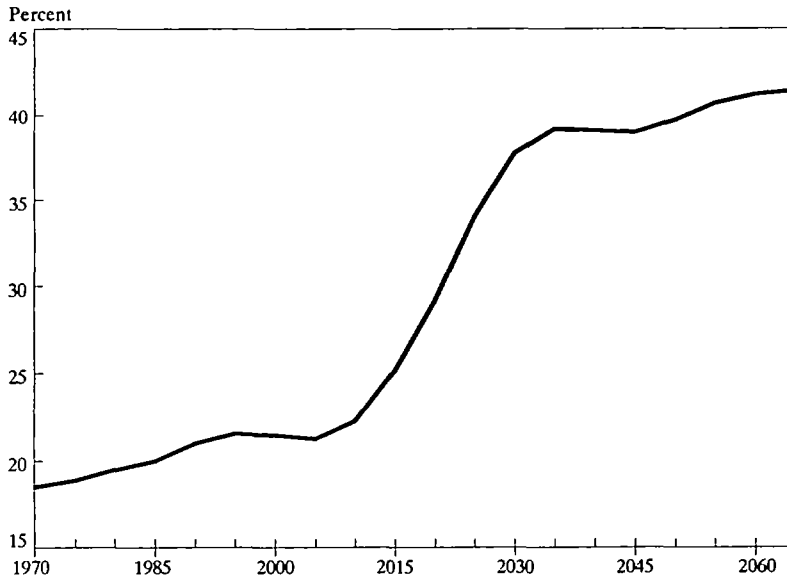
The social security surplus is already large enough to substantially lower the total budget deficit. However, the social security program could help reduce the federal budget deficit even more in coming years because the social security surplus is projected to grow dramatically.

Short-run outlook and budgetary impact. Over the next few years, the social security surplus is unlikely to grow enough to eliminate the budget deficit. As shown in Table 1, the social security surplus is projected to increase sharply from \$56 billion in fiscal year 1989 to \$117 billion in fiscal year 1994. But the deficit in the non-social security portion of the budget is expected to worsen gradually so that the total budget deficit will decline only slowly, from \$155 billion in fiscal year 1989 to \$122 billion in fiscal year 1994. Thus, the social security surplus will help reduce the federal budget deficit in the near term, but will not eliminate the deficit.

Not all of the growth in the social security surplus will contribute to reducing the budget deficit. Part of the projected growth of the social security surplus is due to rising interest payments on Treasury securities held by the OASDI trust funds. These interest payments are expected to grow from \$11 billion in fiscal year 1989 to \$45 billion in fiscal year 1994. Growth of these interest payments worsens the deficit in the non-social security budget by an equal amount, leaving the total budget deficit unchanged. Thus, only growth in the non-interest portion of the social security surplus will reduce the total budget deficit.

Long-run outlook and budgetary impact. Social security could reduce the federal budget

CHART 1
Ratio of elderly population to working-age population



Source: 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds.

deficit even more dramatically over the longer term. The social security surplus is projected to grow so much over the next 25 years that social security could eliminate the federal budget deficit without any changes in other federal programs. However, the elimination of the budget deficit would be temporary because the financial position of the social security system is expected to deteriorate rapidly around the middle of the next century.

The primary cause of these dramatic long-run changes in social security finances will be the aging of the baby-boom generation. As the large baby-boom generation ages, the number of elderly people will increase sharply relative to the number of working-age people (Chart 1). In 1985 there were 20 elderly people (65 years and older) for every 100 working-age people (20-64 years). By 2050, there will be 40 elderly

people for every 100 working-age people.⁴

Such major changes in the age structure of the population are expected to dramatically influence the social security surplus over the next 60 years. Table 2 shows these effects using the Social Security Administration's baseline projections of the social security surplus.⁵ Excluding the interest payments on trust fund

⁴ The population projections are based on the Social Security Administration's intermediate demographic assumptions. 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds.

⁵ These baseline projections are the Social Security Administration's alternative IIB projections. Tables 1 and 2 contain differing figures for the fiscal year 1990 social security surplus because these projections were produced by separate government agencies at different points in time.

TABLE 2
Projected social security surpluses
 (billions of current dollars)

	<u>Including interest</u>	<u>Excluding interest</u>
1990	57.3	41.1
1995	109.6	64.9
2000	184.7	101.1
2005	291.2	144.8
2010	412.1	161.6
2015	482.6	98.9
2020	450.8	-72.4
2025	307.6	-329.1
2030	66.2	-625.8
2035	-250.6	-915.0
2040	-651.1	-1,183.9
2045	-1,292.5	-1,544.3
2050	*	*

*The OASDI trust funds are exhausted in 2048 in the Social Security Administration's baseline projections.
 Source: 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

balances, the social security surplus is projected to rise until approximately 2010. The surplus is expected to grow because payroll tax receipts will rise rapidly as workers from the baby-boom generation experience rising wages. At the same time, benefit payments will grow much more gradually because the baby-boom generation will remain in the work force.

Including interest payments on Treasury securities held by the OASDI trust funds, the social security surplus is projected to grow until about 2015. For a few years, rising interest payments on trust fund balances are likely to

offset a decline in the social security surplus excluding interest payments. Such interest payments have not greatly influenced social security finances in the past because the OASDI trust funds typically have not had large financial reserves. However, the trust fund balances are projected to grow dramatically over the next 40 years, peaking at \$12 trillion in 2030. As a result, the OASDI interest earnings will also become substantial.

But, if the Social Security Administration's baseline projections are correct, both measures of the social security surplus will decline sharply when the baby-boom generation retires. Benefit payments are expected to rise rapidly between 2010 and 2030 as most of the baby-boom generation reaches 65 years of age. In contrast, the working-age population is projected to increase through 2015 and then decline slightly. As a result, payroll tax receipts would grow much more slowly than benefit payments. Either including or excluding interest payments, the social security program is projected to move into deficit, and the OASDI trust funds would be depleted in 2048.

The long-run projections for the social security surplus in Table 2 show that social security cannot permanently eliminate the total budget deficit. Between 1990 and 2010, social security would reduce the deficit as the surplus excluding interest payments grows. However, the social security program would begin adding to the total deficit between 2015 and 2020 when the social security program excluding interest payments is projected to move from a surplus to a deficit.

In summary, it is sensible to think of the social security surplus as a possible solution to the federal budget deficit over roughly the next 25 years. The social security surplus will almost

certainly grow enough to reduce the total budget deficit, and the social security surplus might even eliminate the deficit for a time. But the social security program cannot permanently eliminate the budget deficit because social security is projected to run a large deficit of its own when the baby-boom generation retires.

Social security and future retirement needs

The primary purpose of the social security system, of course, is not to reduce the federal budget deficit. The social security program exists to provide retirement and disability income to participating workers and their dependents. The program has been highly successful in achieving these goals and has substantially improved the living standard of elderly people. In addition, workers have come to rely on social security as a major source of retirement income and have planned their lifetime savings accordingly. The social security program has thus developed widespread political support, which has allowed additional tax revenues to be provided for the program when necessary. But the retirement of the baby-boom generation will put unprecedented demands on the social security system in the next century. As a result, a growing social security surplus is needed to help finance the future retirement benefits of the baby-boom generation.

Meeting the financial needs

Recent legislation has made substantial progress toward meeting the long-run financial needs of the social security system. A financing crisis in the early 1980s precipitated Congressional action. Because social security

benefits were indexed to the cost of living, high inflation rates had rapidly increased social security outlays. In addition, a technical error in the cost-of-living adjustment caused benefit payments to increase more rapidly than was warranted by the gains in wages and consumer prices. Moreover, relatively sluggish wage growth and the severe recession in the early 1980s reduced payroll tax collections relative to outlays, causing OASDI to draw on its trust fund balances in the late 1970s and early 1980s.⁶

The Social Security Amendment of 1983 moved the OASDI programs away from their traditional pay-as-you-go method of financing.⁷ Pay-as-you-go financing provides that benefits to social security recipients in any given year be financed largely by payroll taxes collected from workers during the same year. The social security system accumulated substantial trust fund balances at times in its early years. However, large trust fund balances were not maintained because Congress often used these funds to extend social security coverage to new groups of recipients and increase benefit levels relative to contributions.

The Social Security Amendment of 1983 quickly resolved social security's short-run

⁶ A brief history of social security financing can be found in Alicia H. Munnell and Lynn E. Blais, "Do We Want Large Social Security Surpluses?" *New England Economic Review*, Federal Reserve Bank of Boston (September/October 1984), pp. 6-9.

⁷ The Social Security Amendment of 1983 was based on the work of the National Commission on Social Security Reform (popularly known as the Greenspan Commission). The Commission's conclusions are summarized in *Report of the National Commission on Social Security Reform*, U.S. Government Printing Office, January 1983.

financial problems. The major provisions of the act were raising the payroll tax, especially for the self-employed; taxing half the retirement benefits for high-income retirees; and increasing the retirement age in the future. In addition, the technical error in the cost-of-living adjustment for social security benefits was corrected to ensure that the growth rate of payments per beneficiary would not exceed the general inflation rate. Although the new legislation focused on the immediate financial crisis, these reforms also set social security on a course of growing annual surpluses. As has already been discussed, the resulting increase in financial assets held by the OASDI trust funds should help social security meet its massive obligations to the baby-boom retirees.

But even though recent legislation has improved the long-term financial outlook for the social security system, some further changes in social security taxes or benefits may be necessary to keep the program sound in the long run. The program is said to be in close actuarial balance if the value of social security resources, including current trust fund balances and projected receipts, is within 5 percent of the value of projected future outlays. As the years pass, the social security program is likely to move toward actuarial deficit as surplus years from this century are replaced in the actuarial calculations with deficit years from the next century. Further changes in social security financing, such as moderate increases in payroll tax rates, may be necessary around the turn of the century to maintain close actuarial balance even though the accumulated surplus in the OASDI trust funds would be very large by historical standards.⁸

⁸ Henry J. Aaron, Barry P. Bosworth, and Gary Burtless,

Alternative outlooks

Future social security surpluses might differ from the baseline projections if future economic developments are either more or less favorable than the Social Security Administration assumed in its baseline outlook. The baseline projections reflect the view that future economic growth and inflation will be moderate.⁹ The Social Security Administration has also constructed two alternative outlooks for the social security surplus that are based on either more optimistic or more pessimistic economic assumptions. Although the baseline projections are the most widely discussed, some observers have found the pessimistic projections to be the most plausible outlook because the pessimistic

Can America Afford to Grow Old? (Washington, D.C.: Brookings Institution, 1989), pp. 44-48. In calculating whether the social security program is in close actuarial balance, government actuaries use the present value, or time-discounted value, of social security receipts and outlays.

⁹ In the baseline projections real GNP is assumed to grow about 2.5 percent annually over the next 10 years and somewhat more slowly thereafter. The inflation rate is assumed to remain near 4 percent annually, and the unemployment rate is assumed to stay around 6 percent. Real wages—wages adjusted for changes in the cost of living—are assumed to grow by a little more than 1 percent annually.

Real wage growth is an important source of uncertainty in these projections, because long-run real wage growth could have a major effect on social security finances but is difficult to predict accurately. Real wage growth is nominal wage growth minus the inflation rate. This difference has an important effect on financial projections for the social security system because payroll tax receipts depend on nominal wage growth, while social security cost-of-living adjustments depend on consumer price inflation. The financial condition of social security has deteriorated in the past when consumer price inflation has been high relative to nominal wage growth.

assumptions closely resemble recent experience.¹⁰ In contrast, the optimistic outlook may be less plausible because these projections would require a more favorable economic performance than in recent years.

The alternative outlooks show that future economic performance could have a substantial effect on social security finances. Under the baseline assumptions, the social security surplus would increase until 2015 and would remain positive until shortly after 2030. However, under the equally plausible pessimistic assumptions, the provision for future retirement needs would be less ample because the social security surplus would be smaller and the program would go into deficit about 15 years earlier. In the less plausible optimistic case, social security would avoid a future deficit altogether.

The alternative outlooks also differ substantially in the effects of the social security surplus on the total budget deficit. These differences can be seen by comparing the two most plausible cases, the baseline and pessimistic projections. As an example, suppose the federal government achieves the Gramm-Rudman-

Hollings deficit target of \$100 billion in fiscal year 1990, but all factors other than social security then stabilize at the 1990 levels. In the baseline case, the projected surplus excluding interest payments increases by over \$100 billion from 1990 to 2005, enough to bring the total budget back in balance. But in the pessimistic case, the OASDI surplus excluding interest payments never improves enough to eliminate the total deficit. And, in either case, the total deficit would worsen dramatically when the baby-boom generation retires.

It is possible, therefore, that the social security surplus may never become as large as the baseline projections suggest. Smaller than expected surpluses would cause the long-run financial outlook of the social security system to become less secure. Smaller surpluses would also imply that the social security program could offset less of the deficit in the non-social security portion of the budget.

Thus, a growing social security surplus is needed to help finance the future retirement benefits of the baby-boom generation. And, although the projected surpluses are quite large by historical standards, such surpluses are not excessive in light of the long-run actuarial calculations and the risks concerning future economic conditions. However, to provide adequately for future retirees, the growing social security surplus must help to increase the nation's output of goods and services. The new factories and equipment needed to increase output depend heavily on a key variable, national saving.

National saving and the non-social security deficit

It is important to distinguish between the

¹⁰ Compared with the baseline case, the pessimistic projections assume slower real GNP growth, higher inflation and unemployment, and slower real wage growth. The pessimistic assumptions are closer than the baseline assumptions to the average experience of 1975-87 for the inflation rate, real wage growth, and the unemployment rate. An example of the view that the pessimistic projections are most plausible is Robert M. Giordano, "Pig in a Poke," *Financial Market Perspectives*, Goldman Sachs (July/August 1988), pp. 4-7.

The optimistic and pessimistic projections are the Social Security Administration's alternatives I and III, respectively. The projections also incorporate differing assumptions about such demographic factors as fertility rates and life expectancy. For further details, see *1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds*.

financial effects and the nonfinancial effects of a social security surplus. A surplus provides the social security system with financial resources for future benefit payments but does not necessarily lead to an increase in future real output of goods and services. Yet with the number of retirees projected to increase relative to the working-age population, future real output per worker must increase to provide adequate goods and services to the U.S. population. Current fiscal policy decisions could help produce such an increase in future real output by raising national saving.

National saving and the budget deficit

Current fiscal policy affects the nation's future real output of goods and services primarily because the federal budget deficit affects national saving. National saving is private saving minus government borrowing. The government sector has been a net borrower in recent years because the federal budget deficit has exceeded the combined surpluses of state and local governments. The total budget deficit gives the federal government's effect on national saving because—as noted earlier—the total deficit measures the federal government's overall demand for credit. In recent years, large total deficits have reduced the amount of domestic saving that is available to invest in such private capital goods as new factories and machinery.

Reducing the budget deficit is the primary way that the federal government can increase future real output of goods and services. Because a federal budget deficit reduces national saving, cutting the budget deficit or creating a surplus would raise national saving and lower interest rates. In turn, lower interest

rates would tend to raise net investment spending, investment above that needed to replace depreciating plant and equipment. Over a period of years, higher net investment would raise the stock of private capital goods and, thus, the nation's ability to produce goods and services. Therefore, fiscal policymakers could provide for the material needs of future workers and retirees by reducing the total budget deficit in order to raise future productive capacity.¹¹

Without action to raise future productive capacity, the retirement of the baby-boom generation could adversely affect the living standard of workers and their families in the next century. The living standard is the level of real consumer spending per household. Because social security invests surplus funds in Treasury securities, general tax revenues would be needed in the twenty-first century to redeem these securities and pay retirement benefits. With the proportion of retirees in the population growing, future working-age households are likely to experience tax increases in order to redeem the OASDI trust funds' holdings of Treasury securities. Future tax increases for working-age households would reduce the growth rate of their after-tax incomes and, therefore, of their living standards.¹²

¹¹ This analysis assumes that raising the national saving rate would be desirable. Although most economists probably accept this view, the view is not universal. For further discussion, see A. James Meigs, "Dollars and Deficits: Substituting False for Real Problems," *The Cato Journal* (Fall 1988), pp. 533-53.

¹² However, future working-age households would not necessarily have a lower living standard than working-age households today. Although meeting the retirement needs of the elderly may require higher future taxes, technological change and capital investment are likely to raise real income

An increase in the nation's capital stock, however, would reduce the burden on future workers and their families of producing real goods and services. A larger stock of private capital goods would increase future real output per worker. As a result, the nation would be better able to produce goods and services for both retirees and working-age families. In addition, because future workers would be more productive, firms could afford to pay higher real wages. As a result, future workers would find it easier to pay the taxes needed to redeem Treasury securities held by the social security trust funds.

Thus, reducing the federal budget deficit and providing goods and services for the baby-boom retirees are not contradictory goals. In fact, reducing the total budget deficit would raise national saving and make it much easier to produce goods and services for future retirees. Because social security affects the total budget deficit, growing social security surpluses can contribute to achieving both goals. But larger social security surpluses by themselves cannot guarantee a smaller total deficit because the government budget also depends on non-social security receipts and spending.

Controlling the non-social security budget

To achieve an adequate increase in national

and consumption. Thus, the after-tax income of future working-age households might be higher than at present.

This analysis assumes the baby-boom generation should help provide for its own retirement through a higher national saving rate. However, some economists believe future working-age families should bear the entire cost of the baby-boom retirement through higher taxes. For an example of this viewpoint, see Munnell and Blais, "Do We Want Large Social Security Surpluses?"

saving, the size of the non-social security deficit must be controlled so that the projected growth of the social security surplus will reduce the total budget deficit. In fact, some experts now believe that the federal government may need to run a total budget surplus to provide adequately for the retirement of the baby-boom generation.¹³

If fiscal policymakers limit the growth of non-social security outlays so that the increase in the social security surplus raises national saving, future working-age families would probably experience little or no burden in providing goods and services for the baby-boom retirees. A recent study examined the fiscal policy option of keeping the non-social security deficit equal to 1.5 percent of GNP over the next 60 years. Such a policy would reduce the non-social security deficit from about 4 percent of GNP in 1988. Under this policy, growth of the social security surplus would reduce the total deficit and thereby raise national saving. The study also assumed that social security taxes would be raised whenever the OASDI program slipped out of close actuarial balance. The study found that the higher saving rate would increase the

¹³ For example, see Alan Greenspan, Remarks Before the Economic Club of New York, June 14, 1988, p. 15; and *Report of the National Economic Commission*, U.S. Government Printing Office, March 1, 1989.

If private saving were to increase substantially, there would be less need for a budget surplus to provide for future retirees. Changes in the tax structure might encourage higher private saving by increasing after-tax returns. As Chairman Greenspan recently noted, "It is not clear that past government policies have been very effective in boosting private saving." Alan Greenspan, Statement to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 21, 1989.

capital stock, labor productivity, and real wages. According to the study, such a policy would initially reduce consumption. But consumption would ultimately increase enough to eliminate any burden on future working-age families.¹⁴

Fiscal policymakers may find it difficult, however, to limit the growth of non-social security outlays as the social security surplus expands. The Gramm-Rudman-Hollings targets and recent policy debates have focused the public's attention on the total budget deficit. As shown earlier, this focus is appropriate because the total deficit measures the federal government's effect on national saving. However, the danger is that policymakers and the public might conclude that the current level of the total budget deficit is tolerable. They may become complacent, willing to use the social security surplus to finance higher non-social security outlays.¹⁵

¹⁴ Aaron, Bosworth, and Burtless, *Can America Afford to Grow Old?* pp. 76-91. The authors assumed that adjustments to monetary policy would keep the economy at full employment over the simulation period. In addition, they assumed the added national saving would be invested domestically. The results were derived from simulations with a multi-equation economic growth model.

¹⁵ An important caveat concerning the non-social security budget is that some government outlays have an investment character. Government expenditures for such purposes as improving transportation, educating young people, and conducting scientific research may increase the nation's future productive capacity. The role of government infrastructure investment is discussed in Alan S. Blinder, "Are Crumbling Highways Giving Productivity a Flat?" *Business Week*, August 29, 1988, p. 16; and David Aschauer, "Is Public Expenditure Productive?" *Staff Memoranda*, 88-7, Federal Reserve Bank of Chicago.

However, such arguments do not provide a blank check for using the social security surplus to pay for government

If fiscal policymakers used the growing social security surplus to expand non-social security outlays, future working-age families would likely experience a burden when the baby-boom generation retires. The study cited above also examined the fiscal policy option of keeping the total budget deficit, rather than the non-social security deficit, equal to 1.5 percent of GNP. In comparison, the total deficit was equal to roughly 3 percent of GNP in 1988. In this case, some of the future growth in the social security surplus would be offset by an increase in the non-social security deficit. As a result, there would be less of an increase in national saving to raise future productive capacity and prevent a burden on working-age households. The study found in this case that future working-age households would experience a substantial burden in terms of lost consumption as a result of the baby-boom retirees.¹⁶

As the social security surplus grows, fiscal policymakers may face many pressures to expand non-social security outlays or even to reduce federal revenues. Pressures always exist to expand programs to meet a wide range of social and defense needs. A large social security surplus also might create pressures to increase

investment spending. Economics does not provide clear guidelines about which government investments would enhance productivity and future real output. Indeed, economists find it difficult to agree on the dividing line between government consumption and government investment projects. Moreover, many possible infrastructure projects would not produce enough benefits to justify the expenses.

¹⁶ In particular, the burden would equal 1.8 percent of net national product in the year 2030. Net national product is gross national product minus an allowance for the depreciation of capital goods.

Hospitalization insurance and the budget deficit

In addition to the social security trust funds, the Hospitalization Insurance (HI) trust fund of Medicare is expected, according to the baseline projection, to significantly increase the federal budget deficit in the long run. Hospitalization outlays are projected to grow so rapidly in coming years that the HI program is likely to operate with a deficit before the turn of the century.

The poor financial outlook for the HI program reflects the aging of the U.S. population and projected large gains in medical costs. Because the HI program derives its revenues from payroll taxes on the same group of participants as OASDI, the HI trust fund is also affected by the aging of the baby-boom generation and the smaller size of subsequent generations. In addition, medical expenses are projected to increase because the share of very old people within the 65-years-and-older age category is likely to grow. The very old typically have higher medical expenses than other elderly people. Moreover, U.S. medical costs have grown much faster than the general cost of living. Although the growth rate of medical

costs may slow in the future, medical costs are still projected to grow faster than the general price level. Such factors could produce a deficit in the HI program and thereby worsen the total budget deficit.

One strategy for dealing with a future deficit in the HI program would be to merge the OASDI and HI trust funds so that the large social security surplus would cover the HI deficit. The combined baseline OASDI and HI trust funds are projected to peak at 20 percent of GNP in 2015 and then to decline sharply as the baby-boom generation ages. With no changes in tax rates or benefits, the combined OASDI and HI trust funds would be depleted in 2031 and would sink deeply into debt over the remainder of the projection period. Thus, combining the OASDI and HI trust funds would not alter the basic pattern of an unprecedented increase in trust fund assets followed by a sharp decline. However, the initial buildup of trust fund assets would be smaller, and the combined trust funds would be depleted sooner than the OASDI trust funds by themselves.

benefit payments to current retirees or to reduce payroll tax rates. In addition, pressures may develop in the next decade to divert funds from the OASDI trust funds to pay for the hospitalization expenses of Medicare. (See the box for further details on the Medicare program.) Such pressures will make it difficult for fiscal policymakers to limit the size of the non-social security deficit.¹⁷

be used to fund higher non-social security outlays demonstrates why concern about the effects of the social security surplus on U.S. financial markets is premature. Although the social security surplus could create a shortage of marketable Treasury securities under some scenarios, serious financial problems are not inevitable. The national debt will grow for several years under even the most optimistic assumptions about deficit reduction. Moreover, the pressures for new spending programs and the political difficulties in cutting existing programs or raising taxes may prevent the federal government from ever running total budget surpluses large enough to create a shortage of marketable government debt. For further discussion of these issues, see Alicia H. Munnell and Lynn E. Blais, "Do We Want Large Social

¹⁷ The possibility that growing social security receipts will

Because controlling the non-social security budget has been difficult, some economists and policymakers believe the best way to limit the size of the non-social security deficit would be to separate the social security system from the rest of the federal budget. Separating social security would only alter the *political* process of budgeting, however, not the economic effects of a given social security surplus. The *economic* effects of a given surplus would be the same regardless of the federal budget's format.

The social security trust funds are already considered to be off-budget items in official documentation. The Balanced Budget Act of 1985 required that the social security program be shown as off-budget, or outside the official federal budget.¹⁸ It was hoped that doing so would encourage better fiscal policy decisions by helping taxpayers understand the size of the deficit in the non-social security budget. However, showing social security as an off-budget item has had little effect on fiscal policy decisions because the social security surplus is still included in the Gramm-Rudman-Hollings deficit targets.

Removing the social security surplus from the Gramm-Rudman-Hollings targets might be a more effective way to limit the growth of the

non-social security deficit and to raise national saving.¹⁹ The total budget deficit would remain the best deficit measure for financial and economic analyses, and the social security surplus would still influence overall federal borrowing. However, removing the social security surplus from the Gramm-Rudman-Hollings targets might focus public attention and fiscal policy debates on the non-social security deficit. If such a new focus made it more difficult to increase non-social security outlays, the chances would be improved that the growing social security surplus would raise national saving.

Whether the social security surplus should be removed from the Gramm-Rudman-Hollings targets is not the key issue, however. From an economic perspective, the key point is that the growing social security surplus must increase national saving and the stock of capital goods to provide goods and services for future workers and retirees.

Conclusion

Policymakers would be well advised not to rely on the projected growth of the social security surplus as the main solution to the federal budget deficit. Although growth of the social security surplus will tend to reduce future budget deficits, the social security surplus will not permanently eliminate the total budget deficit. Even if the social security surplus eliminated the budget deficit temporarily, the

Security Surpluses?" and Ethan S. Harris and D. K. Hargreaves, "U.S. Social Security Surpluses: Pitfall or Opportunity?" *World Financial Markets*, Morgan Guaranty Trust Company, July 1, 1988.

¹⁸ Congress had already legislated a move of the social security system to off-budget status in the Social Security Amendment of 1983. Thus, the Balanced Budget Act simply advanced the date for this change in official documentation. Medicare's HI trust fund is also scheduled to join the off-budget accounts in fiscal year 1993.

¹⁹ Arguments for and against including social security in the federal budget are presented in Alicia H. Munnell, "Social Security and the Budget," *New England Economic Review*, Federal Reserve Bank of Boston (July/August 1985), pp. 10-13.

deficit would worsen in the next century when the baby-boom generation retires. And unfavorable economic developments could lead to smaller social security surpluses than in the Social Security Administration's baseline projections.

But perhaps the most important reason for not relying on the social security surplus as the cure for current budgetary problems is the need to increase national saving to raise future pro-

ductive capacity and future output of goods and services. If the United States is to produce enough goods and services to meet the needs of the baby-boom retirees and future working-age households, the growth in the social security surplus must be used to increase national saving. Such a result is most likely to be achieved if policymakers concentrate on controlling the deficit in the non-social security portion of the budget.