

Federal Reserve Bank of Cleveland

What Fiscal Surplus?

by Jagadeesh Gokhale

The United States' economic performance during the last two years has been spectacular. Inflation remained quiescent despite rapid output growth and plunging unemployment. Asset values were buoyed—Asian economic troubles notwithstanding—by upbeat earnings expectations, confidence in continued low inflation, and stability in the domestic economic environment. Strong income growth and increased capital gains realizations raised federal revenues beyond the levels projected earlier. Now, the Congressional Budget Office projects annual federal surpluses through the first decade of the new millennium.¹

In his State of the Union Address, President Clinton urged Americans to reserve “every penny of any budget surplus” to “save Social Security first.” This advice raises several questions, the most important being the size of the projected surpluses and how far they will go to “save” Social Security. An obviously related issue is the total size of the program's shortfall. (Even the word “shortfall” suggests that commitments to pay benefits under current Social Security laws exceed the revenues available to pay them). How do the shortfall and the failure to redress the imbalance affect private individuals' perceptions? And how do these perceptions affect their economic behavior?

The fiscal surpluses projected for the next few years could provide savings to shore up Social Security's finances, but only if they are not accompanied by dis-saving elsewhere. As it happens, fiscal surplus projections have coincided with increased foreign indebtedness, whose immediate causes are trade deficits induced by high consumption levels and correspondingly lower private saving. Could high consumption, lower national saving, and greater foreign indebtedness

somehow be related to Social Security's current financial difficulty?

■ Federal Budget Projections

Uncertainties and Priorities

Recently released Congressional Budget Office (CBO) projections indicate that there will be unified budget surpluses over each of the next 10 years.² By 2008, the surplus is expected to be almost 2 percent of GDP. One major concern, however, is that budget projections are subject to great uncertainty. For example, the CBO's March and August projections differ significantly, and an overwhelming fraction of the change is attributed to a revenue surge caused by “unexplained” factors.³ The CBO itself underscores the fragility of its projections by acknowledging that if any one of several underlying assumptions fails to hold, future budgets will look very different—even if fiscal policies are unchanged. A slower-than-expected future rate of real economic growth, for instance, would lower revenues and render the projections too optimistic.

A second major concern is that although Social Security is the largest federal program today, it will soon be eclipsed by health care outlays. The debate over Social Security's future may be diverting our attention from a more serious—and potentially more difficult—problem. Medicare and Medicaid face much larger shortfalls, which may prove more difficult to bridge than Social Security's because health care programs involve many different types of individuals and institutions—employers, insurance companies, health care professionals, the government, and the public. Saving Social Security alone by using future surpluses, even if that were possible, would not eliminate spending pressures from other mandatory outlays.

Proposals to shore up Social Security using future budget surpluses neglect to mention that Social Security itself produces these surpluses. Moreover, the projected surpluses are dwarfed by Social Security's present shortfall of \$7 trillion–\$10 trillion, which represents the excess of benefits that living adults will receive over their payroll taxes. This shortfall constitutes a net addition to living adults' wealth, and may have encouraged greater current consumption, lowered national saving, and widened U.S. trade deficits.

The Source of Projected Surpluses

If we separate Social Security's account from the rest-of-government account, it becomes obvious that Social Security itself is the source of most of the projected surpluses (see table 1). No surplus emerges on the rest-of-government account until 2006 (line 4), when it begins to contribute a small fraction of the unified budget surplus (compare lines 4 and 12). In 2008, for example, the rest-of-government surplus is ½ percent of GDP and contributes only about a quarter of the unified budget surplus for that year.

Another issue, perhaps more grave, is that the rest-of-government account assumes that discretionary spending will comply with limits established by the 1997 Amendment to the Balanced Budget and Emergency Deficit Control Act of 1985. Although the Amendment specifies discretionary spending limits only through 2002, the baseline budget projections assume that the limits will be extended to keep such spending constant in real terms through 2008. From today's

TABLE 1 PROJECTIONS OF SOCIAL SECURITY AND REST-OF-GOVERNMENT ACCOUNTS AS A PERCENTAGE OF GDP (Billions of dollars)

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|--|------|------|------|------|------|------|------|------|------|------|------|------|
| Rest-of-government account | | | | | | | | | | | | |
| 1. Revenue | 14.7 | 15.2 | 15.3 | 15.0 | 14.8 | 14.8 | 14.6 | 14.6 | 14.6 | 14.6 | 14.6 | 14.6 |
| 2. Outlays ^a | 16.0 | 15.8 | 15.8 | 15.6 | 15.4 | 14.8 | 14.7 | 14.6 | 14.6 | 14.3 | 14.2 | 14.1 |
| 3. Unspecified reductions (UR) | — | — | -0.2 | -0.3 | -0.4 | -0.6 | -0.6 | -0.6 | -0.7 | -0.7 | -0.7 | -0.7 |
| 4. Surplus or deficit (-) [1 - 2] | -1.3 | -0.5 | -0.5 | -0.5 | -0.5 | 0 | -0.1 | 0 | 0 | 0.3 | 0.4 | 0.5 |
| 5. Surplus or deficit except UR [1 - 2 + 3] | -1.3 | -0.5 | -0.6 | -0.8 | -0.9 | -0.6 | -0.7 | -0.7 | -0.7 | -0.3 | -0.2 | -0.2 |
| Social Security (SS) account | | | | | | | | | | | | |
| 6. Reported income | 5.6 | 5.8 | 5.8 | 5.9 | 5.9 | 5.9 | 6.0 | 6.0 | 6.0 | 6.1 | 6.1 | 6.1 |
| 7. Taxes | 5.1 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 |
| 8. Outgo | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.6 | 4.6 | 4.6 |
| 9. Reported surplus [6 - 8] | 1.1 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| 10. Surplus (taxes minus outgo) [7 - 8] | 0.5 | 0.7 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 |
| 11. Surplus (taxes minus outgo) (P) | 0.5 | 0.6 | 0.5 | 0.5 | 0.4 | 0.2 | 0.1 | 0 | 0 | 0 | -0.1 | -0.2 |
| Unified account | | | | | | | | | | | | |
| 12. Unified surplus or deficit [4 + 9] | -0.3 | 0.8 | 0.9 | 0.9 | 0.9 | 1.4 | 1.3 | 1.4 | 1.5 | 1.8 | 1.9 | 1.9 |
| 13. Unified surplus or deficit except UR [5 + 9] | -0.3 | 0.8 | 0.8 | 0.6 | 0.5 | 0.8 | 0.7 | 0.8 | 0.8 | 1.2 | 1.3 | 1.2 |
| 14. Surplus except UR and SS interest income | -0.8 | 0.2 | 0.2 | 0 | -0.2 | 0.1 | 0 | 0 | 0 | 0.3 | 0.4 | 0.3 |
| 15. Surplus except UR and SS interest income (P) | -0.9 | 0.1 | 0.1 | -0.2 | -0.5 | -0.4 | -0.7 | -0.7 | -0.8 | -0.6 | -0.7 | -0.8 |

a. Includes unspecified reductions.

NOTES: Data are for fiscal years. Deficits are indicated as negative numbers. P = Under Social Security high-cost (pessimistic) assumptions. Numbers may not sum exactly due to rounding.

SOURCES: U.S. Congressional Budget Office and Social Security Administration.

perspective, however, it is uncertain that Congress will extend the spending caps beyond 2002. Indeed, existing spending limits could be suspended because of a future economic slowdown or even undone by granting exemptions for certain expenditure items. Thus, prospective policy on spending caps creates additional uncertainty—and may represent unjustified optimism—in current budget projections.

The unspecified reductions in discretionary spending needed to comply with the assumed extension of the caps beyond 2002 are large relative to projected surpluses on the rest-of-government account (compare lines 3 and 4). If we exclude the unspecified reductions, as seems appropriate, the rest-of-government account remains in deficit through the end of the projection horizon (line 5). For 2008, the unified surplus becomes 1.2 percent of GDP—far less than the officially reported 1.9 percent.

Because excluding unspecified reductions produces a deficit on the rest-of-government account, the entire unified surplus comes from Social Security. It is worth recalling that the main purpose of

the 1983 Amendments to the Social Security Act was to change the program from a completely unfunded to a partially funded one. The amendments hiked payroll taxes and scheduled future benefit cuts to create future surpluses to fund the benefits of retiring baby boomers in the next century.

In truth, there can be no “surplus” unless the rest-of-government account has a surplus that could be used to pay off some of the debt held by the public. Because the unified surplus includes the surplus on Social Security’s account, using it to pay down debt held by the public exaggerates the total debt reduction. The decrease in debt held by the public is matched by the increase in debt held in the Social Security trust fund—which will have to be paid down through future tax increases.

The government’s borrowing of the Social Security surplus creates Treasury liabilities that must someday be repaid. That day will arrive when payroll taxes begin falling short of total Social Security outlays. Under intermediate assumptions about demographic and productivity trends, the shortfall will first occur in

2013 and will worsen in each succeeding year. Historically, however, pessimistic assumptions have been more consistent with Social Security’s actual revenues and outlays. This makes it most appropriate to use the pessimistic assumptions, which suggest that payroll plus benefit taxes will begin to fall short of Social Security outlays as early as 2006 and will wipe out the surplus in the unified budget. For example, under such assumptions, the unified budget shows a deficit of 0.8 percent of GDP by 2008 (line 15).

■ How Big Is Social Security’s Problem?

The arguments just given show that it is not sensible to use annual surpluses or deficits for gauging the stance of fiscal policy or to talk about devoting the “surpluses” to saving Social Security. Viewed one way, a surplus seems to exist. From a long-term perspective, however, the notion that there is any real surplus at all is silly—the result of thinking in terms of annual cash flows rather than present values of future revenues and outlays.

FIGURE 1 U.S. NET NATIONAL SAVING

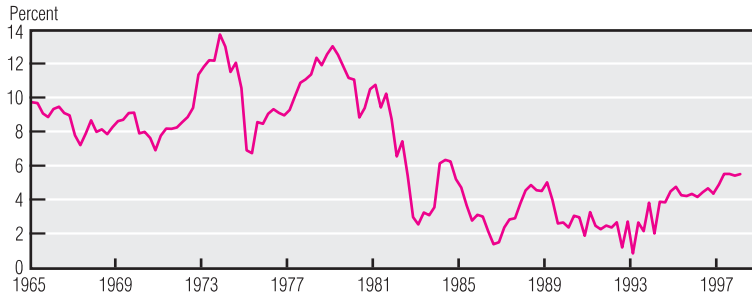


FIGURE 2 U.S. NET INVESTMENT POSITION AT CURRENT COST

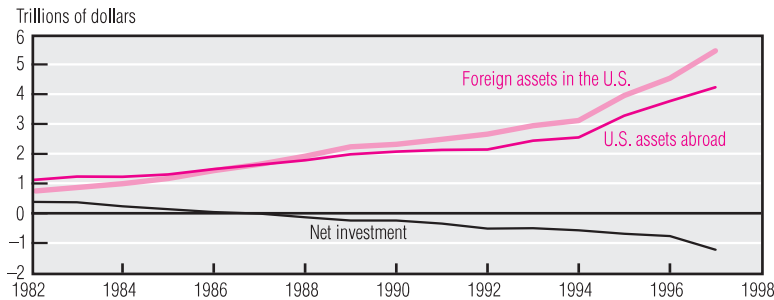
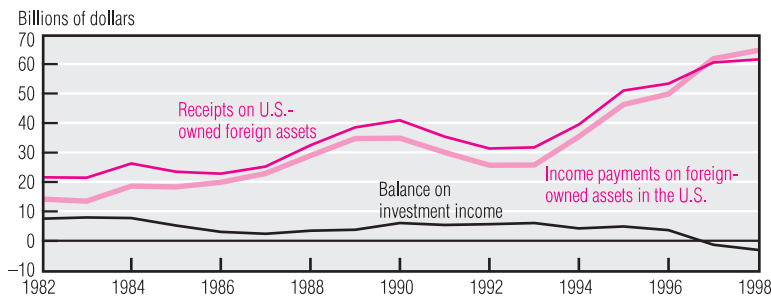


FIGURE 3 U.S. BALANCE ON INVESTMENT INCOME



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

What if we adopt a longer perspective? Several studies show that Social Security's liabilities are huge—between \$7 trillion and \$10 trillion.⁴ These liabilities equal the present value of all future Social Security benefits that the adult population will receive under current laws, less the present value of all future taxes that they will pay. In other words, future adults will have to pay \$7 trillion to \$10 trillion more than the benefits they will receive. However they are measured, the federal budget “surpluses” projected for the next few years are unlikely to equal this shortfall.

The gigantic net liability of future generations accrues because Social Security's benefit payments to past generations exceeded the taxes they paid, and its benefit commitments to current and prospective retirees exceed the taxes they will pay. To today's adults, the prospective excess of benefits over taxes appears as Social Security “wealth”; in reality, it is a trans-

fer from future to current generations representing disposable dollars out of which today's adults can and do consume. Their greater spending, of course, implies a reduction in national saving.⁵

Several studies have analyzed how saving is affected by intergenerational wealth transfers through the Social Security, Medicare, and Medicaid programs and other fiscal policies. One study estimates that transfers from future to living generations account for half of the total reduction in national saving;⁶ another says that Social Security wealth reduces private saving by 60 percent.⁷

■ Offsets to Projected Federal Surpluses

This *Economic Commentary* has contended that projected federal surpluses are much smaller than they appear at first glance and that under appropriate accounting, there are no real (non-Social

Security) surpluses. Moreover, any unified surpluses that do emerge will probably be small relative to the net Social Security liability imposed on future generations. Paying off this liability will become easier if incomes grow faster in the future. The most common way to accomplish rapid income growth is to increase national saving and investment. Unfortunately, the U.S. national saving record for the past two decades has been dismal. In the 1960s and 1970s, our saving was more than 8 percent of our national output; now it averages about 4 percent (see figure 1). It is notable that U.S. national saving declined for two decades after the mid-1970s—precisely when Medicare was growing rapidly and Social Security benefits became more secure and valuable by being indexed for inflation.

National saving and investment must both be high if we are to reap the full benefits of future economic growth. Although borrowing foreign savings enables us to maintain high levels of domestic investment despite a low national saving level, the gain from such investment accrues chiefly to foreigners. This has been our situation for some time. As the U.S. saving rate declined, our domestic investment was maintained at a high level because of foreign capital inflows. Consequently, our net investment position vis-à-vis the rest of the world has changed: Foreign net claims on U.S. assets have exceeded U.S. net claims on assets abroad since 1987, making us a debtor nation (see figure 2).

National saving has shown a minor increase over the last couple of years, but this change is mirrored by a slide in our net investment position abroad. It is, of course, possible that foreign capital inflows are helping to improve worker productivity and maintain high wage levels. However, greater foreign indebtedness inevitably implies a higher future debt-service charge. Recent data on the balance of investment income show that foreigners now earn more on their U.S. asset holdings than U.S. residents earn on assets held abroad (see figure 3). Hence, greater investment and productivity achieved with borrowed capital will benefit U.S. citizens less than they would have had they been financed out of increased national saving.

■ Conclusion

Because the Social Security program itself contributes most of the projected federal surpluses, recommending the use

of these surpluses to “save” Social Security makes no sense. Social Security’s implicit future liabilities—which future generations will have to pay for—do not appear on the government’s books, but that does not mean they don’t exist. Some studies suggest that such liabilities reduce current national saving by inducing living generations to consume more. The burden of these liabilities will be lightened if income growth progresses at a faster rate. However, our current low saving constrains domestic investment. Although it is feasible to maintain a high level of investment and worker productivity through foreign borrowing, the benefits will be lower than those achievable by financing additional investment through greater national saving. Fostering an environment conducive to faster economic growth will require many new initiatives, not the least of which will be reforming Social Security to restore individuals’ incentives to save and invest more.

■ Footnotes

1. See Congressional Budget Office (CBO), “The Economic and Budget Outlook: An Update,” August 1998.

2. “Unified” refers to the federal budget inclusive of Social Security and Postal Service accounts.

3. For example, the CBO’s January 1998 projections indicated a cumulative surplus of \$660 billion between 1998 and 2008. In the August 1998 projections, this figure increased to \$1,548 billion. See CBO, “The Economic and Budget Outlook: Fiscal Years 1999–2008,” January 1998; and “The Economic and Budget Outlook: An Update,” August 1998.

4. See Martin Feldstein, ed., *Privatizing Social Security*. Chicago: University of Chicago Press, 1998. See also John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, “Social Security Money’s Worth,” National Bureau of Economic Research (NBER) Working Paper No. 6722, September 1998.

5. Social Security benefits are provided in the form of annuities during retirement. By insuring individuals against outliving their resources, annuities induce even greater consumption than does support in the form of a lump-sum grant at retirement. See Alan J. Auerbach, Jagadeesh Gokhale, Laurence J. Kotlikoff, John Sabelhaus, and David N. Weil, “The Annuitization of Americans’ Resources: A Cohort Analysis,” NBER Working Paper No. 5089, April 1995.

6. See Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, “Understanding the Postwar Decline in National Saving: A Cohort Analysis,” *Brookings Papers on Economic Activity*, vol. 1 (1996), pp. 315–90.

7. See Martin Feldstein, “Social Security and Saving: New Time Series Evidence,” NBER Working Paper No. 5054, March 1995.

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