Mr. Chairman and other members of the committee, I am pleased to be here today as you begin your discussion of using general revenue transfers to shore up social security and Medicare. A thorough consideration of the options available for placing these programs on a firmer fiscal footing is essential given the pressures that loom in the not-too-distant future. I commend the committee for your efforts to advance this important discussion.

As you are well aware, the dramatic increase in the number of retirees relative to workers that is set to begin in about ten years makes our pay-as-you-go social security and Medicare programs, as currently constituted, unsustainable in the long run. Eventually, social security and Medicare will have to undergo reform. The goal of this reform must be to increase the real resources available to meet the needs and expectations of retirees, without blunting the growth in living standards among our working population and, presumably, without necessitating sizable reductions in other government spending programs.

The only measures that can accomplish this goal are those aimed at increasing the total amount of goods and services produced by our economy. As I have argued many times before, any sustainable retirement system--private or public--requires that sufficient resources be set aside over a lifetime of work to fund an adequate level of retirement consumption. At the most rudimentary level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement. Even better, the resources that would have otherwise gone into the stored goods could be diverted to the production of new capital assets, which would cumulatively produce an even greater quantity of goods and services to be consumed in retirement.

From this perspective, it becomes clear that increasing our national saving is essential to any successful reform of social security or Medicare. The impressive improvement in the budget picture since the early 1990s has helped greatly in this regard. And it appears that both the Administration and the Congress have wisely chosen to wall off the bulk of the unified budget surpluses projected for the next several years and allow it to build. This course would boost saving, raise the productive capital stock, and thus help provide the wherewithal to meet our future obligations.

The idea that we should stop borrowing from the social security trust fund to finance other outlays has gained surprising--and welcome--traction. It has established, in effect, a new budgetary framework that is centered on the on-budget surplus and the way it should be used. The focus on the on-budget surplus measure is useful because it offers a clear objective that should help to strengthen budgetary discipline. Moreover, it moves the budget process closer to accrual accounting, the private-sector norm, and--I believe--a sensible direction for federal budget accounting.

Under accrual accounting, benefits would be counted when they are earned by workers rather than when they are paid out. Under full accrual accounting, the social security program would have shown a substantial deficit last year. So would have the total federal budget. To the extent that such accruals are not formally accounted for in the unified budget--as they generally are not--we create contingent liabilities that, under most reasonable sets of assumptions, currently amount to many trillions of dollars for social security benefits alone. The contingent liabilities implicit in the Medicare program are much more difficult to calculate--but they are likely also in the trillions of dollars. For the federal government as a whole, an accrual-based budget measure would record noticeable unified budget deficits over the next few years and increasing, rather than decreasing, implicit national indebtedness.

The expected slowdown in the growth of the labor force, the direct result of the decrease in the birth rate following the baby boom, means that financing our debt--whether explicit debt or the implicit debt represented by social security and Medicare's contingent liabilities--will become increasingly difficult. I should add, parenthetically, that the problem we face is much smaller than that confronting the more rapidly aging populations of Europe and Japan. Nonetheless, pressures will mount, and I believe that the growth potential of our economy is best served by maintaining the unified budget surpluses presently in train and thereby reducing Treasury debt held by the public. The resulting boost to the pool of domestic saving will help sustain the current boom in productivity-generating investment in the private sector. Indeed, if productivity growth continues at its recent pace, our entitlement programs will be in much better shape. Saving the surpluses--if politically feasible--is, in my judgment, the most important fiscal measure we can take at this time to foster continued improvements in productivity.

The vehicle through which we save our surpluses is less important than the fact that we save them. One method that has been proposed, and that is the focus of today's hearing, is to transfer general revenues from the on-budget accounts to the social security trust fund. These transfers in themselves do nothing to the unified budget surplus. The on-budget surplus is reduced, but the off-budget surplus increases commensurately. The transfers have no effect on the debt held by the public and, hence, no direct effect on national saving. But transferring monies from the on-budget to the off-budget social security accounts could make it politically more likely that the large projected unified surpluses will, in fact, materialize. Given that our record of sustaining surpluses for extended periods of time is not good, any device that might accomplish this goal is worth examining.

Using general revenues to fund social security is an idea that has been considered previously but rejected. Indeed, the commission that I chaired in 1983 was strongly opposed, for a variety of reasons, to the notion of using general revenues to shore up social security. One argument was that using general revenues would blur the distinction between the social security system, which was viewed as a social insurance program, and other government spending programs.

Both social security and, for that matter, Medicare part A are loosely modeled on private insurance systems, with benefits financed out of worker contributions. Like private insurance systems, they are intended to be in long-term balance. But the standard adopted for social security and Medicare part A--that taxes and other income are to be sufficient to pay benefits for 75 years--falls short of the in-perpetuity full funding standard of private pension plans, and, in many years, social security and Medicare have not met even this less stringent standard.

Furthermore, the requirement that social security and Medicare be in long-term balance does not mean that each generation gets in benefits only what it contributed in taxes plus earnings. Indeed, most social security beneficiaries to date have received far higher rates of return on their contributions than that available, for example, on U.S. Treasury securities. But the reduction in the birth rate following the baby boom and the continued increase in life expectancy beyond age sixty-five mean that the social security system will no longer provide workers with such high returns.

Although the analogy between social security and private insurance has never been that tight, the perception of social security as insurance has been widespread and quite powerful. Many supporters of social security feared that breaking the link between payroll taxes and benefits by moving to greater reliance on general revenue financing would transform social security into a welfare program.

But now, when payroll taxes are no longer projected to be sufficient to pay even currently legislated benefits, moving toward a system of general revenue finance raises the concern that the fiscal discipline of the current social security system could be reduced. Once the link between payroll taxes and social security benefits is broken, the pressure to reform the social security system may ease, particularly in this environment of budget surpluses. For example, Medicaid and Medicare part B--both of which will face increasing demands as the population ages--are already financed with general revenues, and, consequently, there has been much less pressure to date to reform these programs.

The availability of general revenue finance when the baby boom generation begins to enter retirement and press on our overall fiscal resources could make it more difficult to argue for program cuts, regardless of their broader merits. As I have testified on many previous occasions, there are a number of social security benefit reforms--such as extending the age of full retirement benefit entitlement and indexing it to longevity, altering the benefit calculation bend points, and adjusting annual cost-of-living escalation to a more accurate measure--that should be given careful consideration. The potential for enhancing efficiency by restructuring the Medicare program is probably even greater than in social security. Relaxing fiscal discipline in the Medicare program by expanding the use of general revenues before the underlying program has been tightened could take the steam out of efforts to improve the way health services are delivered.

That said, I think it is important to note that most government programs are funded through general revenues, so allowing general revenues to finance some of social security or Medicare part A is clearly an idea that would not necessarily eliminate all fiscal responsibility. It might be feasible, for example, to legislate temporary general revenue transfers that would end long before the baby boom generation starts to retire, without opening the possibility of completely eliminating the need for program cuts in social security or changes to Medicare.

It is, of course, difficult to predict the political and economic environment that will be facing policymakers fifteen or twenty years in the future. Legislation passed today that affects the distribution of resources between future workers and retirees could easily be changed later. That is why the most important decision facing policymakers today is not about the distribution of future resources but about the level of future resources available for future workers and retirees. The most effective means of raising the level of future resources, in my judgment, is to allow the budget surpluses projected in the coming years to be used to pay down the nation's debt. The Congress and the Administration will have to decide whether transferring general revenues to the entitlement programs is the best way to preserve the surpluses, or whether better mechanisms exist.