S. HRG. 109–102

LONG-TERM OUTLOOK FOR SOCIAL SECURITY

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

FEBRUARY 2, 2005

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

22–953—PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

CONTENTS

OPENING STATEMENTS

AGENCY WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

LONG-TERM OUTLOOK FOR SOCIAL SECURITY

WEDNESDAY, FEBRUARY 2, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:03 a.m., in room SD–215, Dirksen Senate Office building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Lott, Snowe, Kyl, Thomas, Santorum, Smith, Bunning, Baucus, Rockefeller, Conrad, Bingaman, Kerry, Lincoln, Wyden, and Schumer.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good morning, everybody.

The purpose of our hearing today is to review the long-term financial outlook of the Social Security program. We have in front of us Stephen Goss, Chief Actuary, Social Security, and Douglas Holtz-Eakin, the Director of the Congressional Budget Office.

Social Security is perhaps the most popular government program ever created. Over the last 70 years, it has become part of the fabric of our society. Social Security has kept millions of senior Americans out of poverty. It is a vital part of the safe and secure retirement that we want for every American.

We all have a stake in the future of Social Security. That is true whether you are receiving benefits, just now planning your retirement, or you may be an entirely new person in the workplace. For everybody who is receiving benefits today, Social Security, as you know it, will not change. You can count on those benefits for the rest of your life.

But the same cannot be said for the younger worker. Social Security will not be able to provide the same level of benefits for each generation of our Nation's children and grandchildren.

Social Security, as we know it today, is unsustainable. It will not be able to pay all the benefits scheduled under current law. Both the Social Security Administration, as well as the Congressional Budget Office, have prepared long-range projections of the financial status of the Social Security program.

There are minor differences in assumptions and methods, but both agencies have concluded that benefit payments will exceed payroll taxes within the next 15 years. Both agencies say that Social Security will face rising deficits in the foreseeable future.

Now, many people are skeptical of such long-range projections, and that is understandable. But as we will hear from our witnesses today, Social Security's future deficits are the result of our Nation's changing demographics.

The retirement of 78 million baby boomers, along with rising life expectancies and, of course, the falling birth rates, have produced a declining ratio of workers to beneficiaries, currently 3 to 1, but declining to 2 to 1 over the next 35 years.

When this program was set up in the 1930s, with the first payment being made in the 1940s, I have seen figures saying at least 16 workers were paying for each retiree. As members of the Senate Finance Committee, we sit in the driver's seat when it comes to mapping out the future of this very popular program that is part of the fabric of our society and one that ought to be maintained.

But in this process, and particularly in this body of the Senate where nothing gets done that is not bipartisan, we have an obligation to keep an open mind.

If we make a commitment to build a bipartisan consensus, those of us on this committee can break down the partisan road blocks that threaten the future of Social Security. If we go to work now, we can make incremental changes that will prevent the need for drastic action and more painful choices in the future.

It is part of our responsibility to address this issue right now, before the situation gets worse. We have people say, I will not increase taxes. We have heard other people say, I will not decrease benefits.

Some have said the same thing, will not increase taxes or decrease benefits. That was said prior to 1983 when, all of a sudden, we had to do both, increase taxes and decrease benefits. So we know what lies before us. We ought to be open to opportunities for compromise. We have a chance right now to make public policy for the public good.

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. I deeply appreciate your usual, customary, and well thought out comments, especially with respect to the need for bipartisan working together.

Clearly, if we are going to successfully address the long range challenge with respect to Social Security, we are going to have to do it working together. That is the only way it is going to work. I, again, thank you for this promise. As you well know, that is the way we want to approach this, because it is the only way of getting it to work here, after all.

I would like to sort of begin, though, by noting that 70 years ago, back in June of 1934, President Roosevelt sent Congress a message calling for Social Security legislation. For generation after generation since, workers have paid for, and earned, Social Security insurance.

For generation after generation, Social Security has provided valuable insurance that helps, in the 1935 words of Finance Committee Chairman Harrison from Mississippi, in "meeting some of the major economic hazards of life."

Social Security has greatly reduced poverty. Today, 10 percent of our seniors live in poverty. Without Social Security, more than half of seniors would, today, live in poverty, in what Senator Harrison called "the gaunt specter of need in old age."

Social Security is the only source of income for one-fifth of Americans over age 65. It is more than half of the income for two-thirds of seniors. So, we have to make sure that this program can pay those promised benefits to those who have earned them.

Under the estimates of either of the experts before us today, Mr. Goss and Dr. Holtz-Eakin, Social Security can pay full benefits for 4 to 5 decades into the future. After that, Social Security can still pay 70 to 80 percent of the benefits each year from payroll taxes coming in.

Plainly, we are going to need to strengthen the program—that is clear. Everyone knows that—so that we can pay full benefits beyond 4 or 5 decades. The sooner we act, the less painful the solutions.

Social Security faces a long-term challenge, but it is not in a crisis. In 1983, we were within several months of where we could not pay full benefits. That was a crisis. Today, we can pay full benefits for the next 40 to 50 years.

Yes, Social Security costs money. It is not free. In 1935, Senator Wagner from New York acknowledged that very clearly and plainly. But he also said, "In truth, your argument addressed to cost overlooks the simple fact that every civilized community does, and must, support its old and dependent people in some way."

Continuing, Mr. Wagner, then commenting in 1930, said, "We have been doing it largely by inefficient relief methods, by shabby pension systems, by imposing burdens upon millions of younger members of families, with the consequent impairment of their industrial efficiency and morale, and their own opportunities for future independence." That is what life was like before Social Security, and we do not want to go back there again.

President Bush has hinted that his preference for addressing Social Security's challenges is contained in Model 2 put forward by the President's Commission on Social Security.

Both the experts here today have analyzed that, and this is a great opportunity, Mr. Chairman, for all of us to ask questions of both of them and flesh out what these plans—especially Plan 2—do and do not do.

I have the highest regard for our two witnesses today. They are very, very intelligent, they are smart, independent-minded, and they are what public servants should be in the truest sense of the term. I want to thank you very much, both of you, for attending.

The plan has two major parts. First, it would divert Social Security payroll taxes into new, private savings accounts. By diverting Social Security payroll taxes into private accounts, it makes the long-range financial problem of Social Security worse. Not better, but worse. Privatization, like that in Model 2, will make Social Security's financial problem worse by more than $4 trillion.

Second, in order to reduce the costs associated with the private accounts, Model 2 would deeply cut Social Security benefits for future beneficiaries by changing the way benefits are calculated. These benefit cuts would apply to everyone, not just to those who take private accounts, but those who do not choose to have the private account.

What is more, beneficiaries would not get to keep all their money in their private accounts, a point that is not commonly yet understood. They would have to give back a lot of money when they retire.

But even with the benefit cuts and the private accounts, Social Security would still have a long-running financial problem of over $2 trillion. The cost of Model 2 to taxpayers starts immediately. As payroll taxes are immediately diverted into private accounts, the cost to the government starts right away.

The savings to the government for not letting you keep all of your private accounts do not kick in until people retire. Most of the participants of Model 2 will not retire for many years. As a result, the government would run up massive increases of Federal debt right away, as much as $2 trillion in debt in the first decade. That is on top of the $4.3 trillion in publicly held debt that we already have to date.

But Model 2 is not limited to private accounts. It also includes deep benefit cuts for retirees and a change in the way benefits are calculated. When I say "deep," I mean painfully and unnecessarily deep. For Model 2, additional benefits for future retirees will be cut drastically.

For someone who is in his or her mid-30s right now, the benefit cut will be about one-fourth. For someone born in the year 2000, one of our young children or grandchildren, the cut would be about half. That is not the legacy that we should leave to our children.

If the change in benefits of Model 2 had been in place when Social Security began to pay benefits in 1940, then 7 million more seniors over age 65 would live in poverty today. Seven million. This change in the way benefits are calculated would have cut benefits for those seniors by about 60 percent. These are estimates by the CRS. Mr. Chairman, I ask that they be included in the record.

The CHAIRMAN. Yes, they will be.

[The information appears in the appendix.]

Senator BAUCUS. But you might say, I just will not participate in private accounts and then I will not have my benefits cut. Guess again. These cuts will apply even if you do not choose to participate in private accounts. That does not seem fair to me, and may not seem fair to millions of Americans.

The advocates of privatization tell us that these benefit cuts will be made up by the income that seniors will get from private accounts. Unfortunately, that is wrong, too.

The Congressional Budget Office tells us, even with the income from the private accounts, workers with average earnings who were born between 1970 and 1980 and retire at age 65 will have their total retirement income—that is, their Social Security benefits plus their income from the private accounts—cut by about one-fourth below what they can expect from Social Security under current law. They get less than current law.

CBO also tells us that those with average earnings born in this decade who retire at age 65 will have their total retirement income cut in half. Totally cut in half. The Chief Actuary projects a cut of about a third in the total retirement, relative to benefits scheduled under current law, for a one-earner couple born into this decade with average earnings who retires at age 65.

So, the bottom line is clear. Under estimates from either set of experts under Model 2, even if you participate in a private account, you are going to have much less retirement income than you are currently promised to receive under current law.

But even with the deep cuts in benefits, Model 2 will still cause the Federal Government to accumulate a massive increase in debt which is already $4.3 trillion. We can expect to be adding trillions of dollars more to the debt if the rest of the President's budget is enacted. I do not believe that is fiscally responsible.

The kind of plan that the President seems to be suggesting would be deep benefit cuts for retirees. It would also mean massive increases in debt for the Federal Government. I think that is a bad combination, and I am very concerned.

So we have, today, two of the country's top experts. I look forward to their testimony. But what is more, I look forward to keeping foremost in our minds why we have Social Security.

Seventy years ago, the Finance Committee watched as several elderly gentlemen who were totally blind were led into the committee room by their guide dogs and told of their need in life. That is, before Social Security.

Senator Harrison said, "I do not know of any committee that has ever been moved more than was the Finance Committee."

Today, as you listen to cold numbers and hard facts, let us not forget why Social Security is here and why we have to preserve it and protect it for the future.

Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Thank you.

Mr. Goss, are you going first?

Mr. GOSS. Yes, sir.

The CHAIRMAN. Proceed.

STATEMENT OF STEPHEN GOSS, CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION, WASHINGTON, DC

Mr. GOSS. Chairman Grassley, Senator Baucus, members of the committee, thank you very much for the opportunity to come and speak with you today on this important topic.

Our trustees have been making annual reports to the Congress, as required by law, since 1941. The Office of the Actuary and its predecessors have been making estimates for those reports since even before the inception of the program back in 1935, so we have a wealth of past experience on this, and we hope that this will be of some use to you in considering these topics.

I would like to speak to you today about three primary things. One is the actuarial status of the program, which is required by law to be presented in these reports annually. The second is the reason why these shortfalls are coming upon us in the relatively near-term future. The third is some of the measures of solvency that we deal with when talking about Social Security.

First, why are we where we are? In the 2004 trustees' report, the intermediate projections indicate that the annual excess of tax income over program costs will begin to decline in 2009, and in 2018 the cost will exceed tax income.

At this point, the accumulated trust fund assets of about 2.3 trillion present-value dollars will begin to be used to augment tax income so that benefits scheduled in current law will continue to be paid in full.

Graph 1 shows an illustration of the trust fund ratios that are projected in the latest trustees' report. If no changes are made, it is projected that the combined trust fund assets of the Social Security program will become exhausted in 2042, as you have noted. The program at that point would no longer be considered to be solvent.

What this means is that we would no longer be able to pay fully benefits scheduled in current law on a timely basis. Instead, we would be able to pay 73 percent of scheduled benefits, based on the trustees' intermediate projections, at that time with the continuing tax revenues that would be coming into the program.

After 2042, program cost is projected to continue growing faster than tax income. By 2078, it is projected, under the intermediate projections, that 68 percent of scheduled benefits would be expected to be payable.

What this indicates to us is that the scheduled benefits in current law are, in fact, not sustainable given the scheduled revenues for the program. As the President said, there is a need for strengthening Social Security.

One point that I would like to emphasize is the uncertainty about our projections, whether they are 5 years into the future, 50 years, or even longer. On Graph 1, where we have presented to you the projections the trustees have of the trust fund ratios—and, fortunately, they are not dissimilar in any terribly meaningful way from the ones that CBO has produced. We have also put on some dotted lines for a high-cost and low-cost alternative. This is just to convey, importantly, the fact that there is a lot of uncertainty, and increasing uncertainty as we go into the future.

The dotted lines for the high-cost and low-cost alternative encompass a range which, based on our recent stochastic projections that we have been doing for the last 2 years, indicate that one might think there is something like a 95-percent probability that we would fall between those two dotted lines. So, there is a lot of uncertainty. I would like to speak to you second about the reason for the shortfall, which does give us reason to believe that there is a relatively high likelihood that something close to our central projection will, in fact, be the case.

The second sheet, Graph 2, presents one of the principal themes that I would like to carry to you today. The reason for the increasing cost of our program between 2010 and 2030 is really the shift in the total fertility rate, the shift in birth rates that has occurred.

As we all know, the baby boom generation, born between 1946 and 1965, come from a time of high birth rates. In fact, the average birth rate for a woman's lifetime was, at the time, averaging about 3.3 children per woman.

By 1972, the end of the baby boom had occurred, and, in fact, birth rates had dropped down to a level of only two children per woman, and they have persisted at essentially that level. In the future, we are projecting that we will stay at about two children per woman.

So what are the implications of having the birth rates drop that much? Graphs 3, 4, 5, and 6 show the result. Graph 3 is a purely population- or demographic-oriented measure which flows very strongly from the drop in fertility rates, the shift down in fertility rates that we had some 35 years ago.

What happens when you have a shift down in the birth rates is that your aged dependency ratio, which is defined as the number of older people in the population, 65 and over, divided by the working-age population, age 20 to 64, shifts up after a time.

The reason that this is very, very important, is that the aged dependency ratio is exactly what you have to look at and consider in determining what the ongoing, year-by-year cost is of a program that is financed on a pay-as-you-go basis, which Social Security essentially is.

Graph 4 is the often-cited ratio of covered workers to beneficiaries, which is, and has been for the last couple of decades, at a level of about 3.3 workers per beneficiary.

Because of the shift in the population, we are projecting that this ratio will indeed drop down to about two workers per beneficiary.

You can see the leading edge of this graph with a rapid drop until about 1975.

Most of that drop was because of the maturation of the program. Initially when the program was founded we were giving benefits to only relatively few people, but virtually all the workers were being covered under the program.

It is not until close to 1975 where the changes in population, the changes in aged distribution, begin to direct what is happening in this worker-to-beneficiary ratio.

The bottom left panel (Graph 5) is just the flip, the reverse, of Graph 4. It shows you the number of beneficiaries per 100 workers. It is instructive to look at this. As you can see, it is virtually the same as the purely population-based Graph 3. So, our ratio of beneficiaries to workers follows directly from what happens to the population itself. It is largely a population-driven concept.

Finally, Graph 6 has again exactly the same shape. Graph 6 is the cost rate, which we define on an annual basis as the cost of the program as a percentage of our tax base, of the taxable payroll that is available for assessing payroll taxes.

We have exactly the same shift occurring again, because of the shift in fertility rates that we had 35 years ago shifting to a lower level. We also have a shift up in this cost rate facing us, and it will be coming between 2010 and 2030.

Now, you will note that, both before 2010 and after 2030, there is some tendency towards a drift up in all of these graphs. The reason for that is that, in addition to fertility, there is the other important population parameter, which is mortality, or life expectancy.

There is, there has been, and we expect there will be, continued drifting upward in life expectancy, and that does cause some continuing increase in the cost of the program relative to our tax base.

The picture that I would like to leave in your minds is that of the cost rate, and this is on Graph 6. We have a full panel of this. It carries exactly the same message, the shift in the birth rates will give us this decrease in the cost rate.

Is this a certainty? Nothing is certain for the future, obviously, but there is a very, very high likelihood that this is what we will be facing. In our high-cost and low-cost scenarios there is also a decided shift up in the level of the cost of the program as a percentage of the payroll. So, this is pretty much a given for what we are facing for the future.

The last page of the testimony I presented describes some of the financial measures that we look at, thinking about and assessing the solvency of Social Security, and also in assessing what the different proposals will accomplish in terms of improving the solvency of Social Security.

Solvency, first of all, for Social Security, is really a point-in-time concept. As I mentioned before, the program is solvent at a point in time if we have enough money to pay the scheduled benefits in full and on time. That occurs if the trust funds, in fact, are positive, if they have not been exhausted.

The reason for this is that Social Security does not have any borrowing authority. So if the trust funds run out, and taxes are less than income, then we cannot pay benefits in full. We simply pay what the taxes allow.

Another concept which we have developed over the past decade or so, in response to the enactment of the 1983 amendments and the desire to make amendments in the future somewhat different from those, is the concept of sustainable solvency.

When we talk about sustainable solvency, we mean that we want more for the next 75-year long-term projection than to have a positive trust fund throughout that period.

We are also hopeful that we will have a sustainable trend line toward the end of the period. One way of looking at that is for the trust fund ratio—the first graph I presented—to be stable or rising at the end.

If the trust funds are stable or rising at the end of the period, then we know that we should expect to be solvent, not just for the 75-year period, but for the foreseeable future beyond.

So, that is the principal message we have been carrying for the past decade. Proposals done by the 1994–1996 Advisory Council, and by many individuals in this room and elsewhere in Congress, have all been guided by this concept of moving not just toward solvency for 75 years, but toward sustainable solvency. Those two mutual goals are very important.

The final thing I would like to address is that we have some additional measures, summary measures, which are very useful and very important.

These measures relate to the unfunded obligation of the program and they tend to be computed for a long time period, summarizing the overall effect of the income and of the cost for those periods of time as a whole.

They have some usefulness, but they are not as useful as looking at the trend line that we see from the cost rates and the trust fund ratios. One of these summarized numbers has been in the trustees' report for decades. It is what is referred to as the actuarial balance.

The actuarial balance under our intermediate projections for the 2004 trustees' report was a deficit of 1.89 percent of payroll. There are other ways of expressing that unfunded obligation over 75 years, one of which is that the shortfall represents 0.7 percent of Gross Domestic Product over that 75-year period as a whole.

It can also be expressed in terms of the aggregate present-value dollar amount of $3.7 trillion over the period. The thing to keep in mind with this number is that it is a shortfall that is added up for a long period of time, for 75 years, and there is a lot of uncertainty.

Additional measures that we have dealt with have covered the infinite horizon. These have been brought into the trustees' report for the last couple of years. These numbers are, of course, larger on the present value basis because the infinite horizon obviously covers much more than 75 years.

The $10.4 trillion shortfall that we have estimated for the infinite future is something that should be kept in perspective because it is a shortfall that has to be met with changes that occur, not just for 75 years, but are spread over a very, very long period of time, and there is high uncertainty.

Finally, the test of sustainable solvency, as it has been used for the last 10 years in developing proposals, if met, indicates that the Social Security program would be expected to pay scheduled benefits on a timely basis for the foreseeable future.

It means that the program is on a financially sustainable path. Currently, the Social Security program is in need of some combination of reductions in cost and increases in income to meet this objective.

Because of the upcoming shift in the cost of the program, closely related to shift in birth rates and other demographic variables, the shortfall can be met by changing the levels of benefits or income with a gradual transition over several decades.

Accordingly, acting well before we approach the expected date of trust fund exhaustion will be highly advantageous. By enacting needed changes sooner, we will have more options to consider, we will be able to phase in the changes in a more gradual fashion, and we will be able to give affected individuals more advance notice.

Thank you very much for the opportunity to come talk to you today.

The CHAIRMAN. Thank you, Mr. Goss.

[The prepared statement of Mr. Goss appears in the appendix.]

The CHAIRMAN. Now, Dr. Holtz-Eakin.

STATEMENT OF HON. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. HOLTZ-EAKIN. Thank you, Chairman Grassley, Senator Baucus, members of the committee, for the chance for the Congressional Budget Office to appear today.

Social Security is a very important program. It is a very important part of economic policymaking in the United States. The program influences how much people work, how hard they work, and when they choose to retire.

It influences their decisions to save, how they allocate those savings into different kinds of possible investments, and, as a result, it affects their retirement incomes. And, for the population as a whole, it affects the distribution of income, both for people at any point in time, elderly versus non-elderly, and across generations.

Because it has those kinds of influences, it can also influence how the U.S. economy grows, its overall accumulation of wealth and standards of livings in the future.

It is also an important budgetary issue. It is the single largest program in the Federal budget at the moment. Outlays are about $500 billion. For those reasons, I thought I would spend my time looking beyond the range of the program itself that I think Steve has laid out so nicely and talk about some of the issues and challenges from the perspective of the larger Federal budget and the economy as a whole.

A starting point for doing that is to look at the future of the current Social Security program under current law, and that is in the charts in front of you and on the easel to my right.

What you see is that, at the moment, revenues dedicated to the Social Security program—payroll taxes and taxes on benefits—exceed outlays on Social Security benefits paid to new retirees and current retirees. That surplus, the blue line above the red line, is right now about $80 billion.

It will peak in 2010, roughly, at $100 billion, and then will begin to diminish thereafter until roughly 2020, at which point the program will hit balance. The money that is coming in will exactly match the monies going out.

At that point, Social Security will cease to provide a cushion to the remainder of the Federal budget and will at that point require funds from the remainder of the Federal budget.

That condition will persist under current law until the trust funds exhaust—in our estimate, in 2052—at which point in the process that Steve described, the outlays and benefits paid will be brought down to payroll taxes coming in, and the two lines will match up for the foreseeable future. So, clearly, some form of the current program can sustain into the future.

Importantly, that form does not coincide with the chart on my left, and also those in front of you, which is scheduled benefits as presented under current law, the top line, and scheduled financing under current law, the blue line at the bottom, where the scheduled benefits rise above scheduled financing for as far as the eye can see, representing a gap out at the end of about 2 percent of GDP.

If left in that form and unchanged, that would require, in current dollars, something on the order of $240, $250 billion per year from the remainder of the Federal budget to keep the program in that condition.

So I think looking at it from this budgetary perspective informs a couple of the issues that present to you today. One, when is this an issue? That is in the eye of the beholder. But certainly, as one moves from the left to the right, under current law or the program as scheduled, you will see a diminishing cushion from Social Security to the remainder of the Federal budget.

You will see, ultimately, that cushion disappear, and rising demands from the remainder of the Federal budget, that swing from roughly $100 billion in 2010 to needing $100 billion 15 years later, will manifest itself as budgetary pressures on the remainder of the decisions that you make, and it will take place in the context of rising expenditures under current law for the health programs of Medicare and Medicaid, which will not make it easy, to say the least, to find those funds in the remainder of the budget. But the inexorable arithmetic is, it will be necessary to cut spending on other programs, raise taxes, or to borrow more.

Stepping back from that and looking at the issues from an economic policy perspective, I think it would be useful, as a matter of first order of principles, to resolve uncertainty about the future of the program.

Beneficiaries will be able to make plans, workers will be able to decide what they can count on in the way of Social Security, employers will have certainty about their responsibilities in the program, and policymakers will have a clearer idea about the net budgetary implications that will come from this source and be able to resolve them versus the other demands.

It is also true that there are probably three other things that stand out. The threshold question is: is this the right Social Security system for the 21st century? In the face of changing demographics, is it possible to reconfigure the program to be sustainable over the long term?

There are many issues on the table regarding how that might be done, but I think it is important to recognize that, from a really big-picture perspective, the threshold question that keeps arising is, is it useful to have a system with more pre-funding?

Those who favor pre-funding tend to focus on the reliance of individuals in doing that funding, and on the impacts that might have on incentives for labor supply and for personal saving, on the potential for higher rates of return that come with a pre-funded system versus a pay-as-you-go system.

Those who favor reconfiguring a pay-as-you-go Social Security system point to the universality of the system. They note that it allows for the potential to redistribute income and to provide Social Security insurance against the possibility that your labor market outcomes are not what you had anticipated, that you were struck by disability, or simply live in bad economic times. It gives you a standard of living independent of those events.

In either event, the CBO is happy to be here today to provide information to you from the perspective of not only the program itself, but from the larger budgetary perspective and economic policy, and to assist you as you deliberate the future of this important program.

Thank you.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

The CHAIRMAN. We will have 5-minute rounds of questions. I have the list here in front of me. I will not go down the entire list, but the first six people would be: Grassley, Baucus, Thomas, Conrad, Bingaman, Wyden. Practically everybody is here or will be here, but I would ask that we be, at least in the first round, respectful and observe the 5 minutes, including the Chairman and Ranking Member.

Social Security's actuarial deficit—this is for you, Mr. Goss—is 1.89 percent of taxable payroll. Now, some people have suggested that if Congress were to increase the payroll tax or reduce benefits by that amount, 1.89, that Social Security would be solvent then for 75 years.

However, as I understand the current projections, the annual benefits payments will exceed annual payroll tax receipts by nearly 6 percent at the end of the current 75-year projection period. So, how can a tax increase or benefit reduction of 1.89 fix a deficit of nearly 6 percent?

Mr. GOSS. Chairman Grassley, that is a very good question, and a very important point. The measure of actuarial balance, one of the unfunded obligation aggregate measures that I mentioned earlier, is really intended just to convey the order of magnitude of the size of the problem for the period as a whole for the 75 years.

In fact, the shortfalls over the 75-year period which are not evenly spread over the 75 years do turn out to be equivalent to 1.89 percent of the taxable payroll over that period as a whole.

You are exactly correct, though. If we were to—and I do not believe anybody is recommending this—raise the payroll tax rate by 1.89 percent, that would, indeed, create a trust fund that would carry us for solvency through 75 years.

However, at the end of that 75-year period, the trust fund would be dropping very rapidly and we would be in exactly the situation you described, where, rather than a 5.9 percent shortfall in the cost of the program relative to the tax income, we would have a shortfall of about 4 percent. So, we would have solved about one-third of the problem from the point of view of sustainable solvency, however, we would have accomplished 75 years of solvency.

If I may just suggest, the two things that we really have been focusing on are: solvency for 75 years, and 1.89 would indeed achieve that; and sustainable solvency. Being on a sustainable path thereafter, would in fact not be accomplished by that measure.

The CHAIRMAN. You answered one follow-up question.

I had another one. In your opinion, what is the best way to determine whether or not Congress has adequately addressed the Social Security financial problem from the standpoint of the statistics or the matrix that you have been given?

Mr. GOSS. That is an extremely good question. I guess I would argue, based on the measures and the numbers that we have developed in the trustees' report, that achieving solvency for the 75-year period and achieving sustainable solvency are the goals that we would suggest that people might want to target.

It would require that the trends in the cost and the income of the program be brought at least much closer together, if not meeting, and that they be trending in the future in a manner where they would stay close together.

If those conditions were met, then we will achieve the sustainable solvency concept of having the trust fund ratio be stable or rising in the future, which is exactly what we would need in order to say that, for the foreseeable future, we believe that Social Security will continue to be solvent.

The CHAIRMAN. And following up on that point, how much would Congress have to raise taxes or reduce benefits to achieve this sustainable solvency? Is this bigger or smaller if we were to wait a year, 2 years, or 3 years and not act today, let us say?

Mr. GOSS. The answer to that depends on when the changes would be taking place. If the changes that would be taking place to meet shortfalls in 2042 or 2052, or some earlier date, are to actually take effect in those years, then whether we enact them this year or next year will not truly affect the level of the cost to the population, to the economy in the year in which those take effect.

Our measurement of those shortfalls may vary. For example, when we look at numbers that are expressed as a present value, when we do those based on our 2004 trustees' report, we discount these future shortfalls back to the point of the beginning of 2004.

When we have progressed to the 2005 report in another couple of months, we will then be discounting dollar amounts back to the beginning of 2005, so all the numbers will be measured as being about 6 percent larger.

However, in terms of the actual impact of what we will be facing to meet the challenges in the years 2018, 2042, 2052, the size of the impact on the economy and the population will really be essentially the same at those points in time.

The CHAIRMAN. Dr. Holtz-Eakin, when people talk about Social Security they often focus on a couple of so-called key dates. These dates include the year that benefits exceed taxes and the year that the trust fund is exhausted.

Most people understand the significance of the first date in terms of the government's cash flow. Most people understand the significance of the second date in terms of the government's legal authority to pay benefits.

However, there seems to be a lot of confusion about the period of time between these two dates. Could you explain what happens between the time benefits exceed payroll taxes and the time that the trust fund is exhausted? For the benefit of members, if you get the first word out of your mouth before the red light goes on—— [Laughter.]

Dr. HOLTZ-EAKIN. Let me say at the outset that I want to echo the remarks Steve made about the uncertainty surrounding these projections. I think the important thing is that the profiles are dictated by demographics and the structure of the program. Exact dates will shift some. There is no real difference in the outlook between the Social Security Administration and the CBO.

So, during that period when benefits begin to exceed payroll taxes, mechanically, what will happen is, the trust fund will finance Social Security. There is no question that the bonds in the trust fund will be honored. The question is how, from a budgetary perspective, that honor will be kept.

Figuratively speaking, the Social Security Administration—I like to think of Steve showing up with the bonds in his hands—will come back to the Treasury and ask for the funds, and the Treasury will have to provide those funds and either do so by reducing spending somewhere in the budget, raising taxes, or borrowing it from the public. That will continue for decades.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

In the interest of trying to figure out Plan 2, in the greater interest of using that information so we can get a better idea of how we can solve the shortfall in the trust fund, I just have a couple of questions about the private accounts.

It is my understanding—and I want to compare them with, say, 401(k)s—that some compare the private accounts in Plan 2 with

401(k)s. You get your money and you set it aside, you can invest it and get a good return. The rate of return is better than the Treasury interest rates for Social Security. That is generally how some explain it.

But is it not true, though, that under the plan, when somebody chooses to divert, say, 2 percentage points of payroll taxes into a private account, that when that person then retires, that persons under Plan 2 are not able to keep the principal with the interest in the account? That goes back to Social Security.

The theory is that that is not your money, that is the government's money, where the 401(k) is your money. That is why, under 401(k), you keep the principal. You get to keep the principal. But I understand that, with Plan 2, it is not your money, it is the taxpayers' money. It is government money.

You also get to keep the full rate of return, because whatever return you might get that is positive is diminished by the Treasury interest rate less a percentage point, which I understand is not 3 percentage points, it is .352 percentage points. So, taking an average calculation, say you are going to put $40,000 into an account, and let us say the net is 3 or 3.5 percent.

Let us say 3.5 percent. That will give you, what, $14,000 earning, total. You cannot get the $40,000 back because that is not yours. You cannot get all the rate of return back, because that is not the way the plan works.

So is it not true that with Plan 2, you get much, much, much less back because you do not get the principal, and you also do not get the full rate of return back, whatever it might be, less administrative costs? Is that accurate? You both can answer that question, please. Under Plan 2.

Dr. HOLTZ-EAKIN. Well, Plan 2. A simple way to think about it that helps me——

Senator BAUCUS. Did I describe it accurately? That is the question.

Dr. HOLTZ-EAKIN. The way I would describe it, and let us see if they match——

Senator BAUCUS. Is it generally accurate or not accurate?

Dr. HOLTZ-EAKIN. Well, it is a labeling issue, so let me just lay out the labels.

Senator BAUCUS. All right.

Dr. HOLTZ-EAKIN. Plan 2 changes the traditional benefit in Social Security and it adds the individual accounts, two different steps. In your description of step two, monies carved out in the individual account earn rates of return, depending on the investment.

One arrives at retirement. At that point the traditional benefit is calculated and is based on the total contributions made to that individual account over your working career.

So, it is true that the traditional benefit depends on how much you put into the individual account and pretends that those contributions earned a Treasury rate of return. That is part of a calculation of the traditional benefit.

The second thing, which is who owns the money, I would highlight to this committee, details matter. Commission Plan 2 is far from a legislative vehicle. It is a model.

One of the outstanding issues that we at CBO have thought pretty hard about, is the nature of the annuitization process at the end of an individual account. So, I do not know who owns that money. That will depend on how it is drafted.

Senator BAUCUS. I am trying to time my questions so I can ask a question just before the red light goes on. [Laughter.]

Dr. HOLTZ-EAKIN. I am going to give him a shot.

Mr. GOSS. Might I answer that, if I can? I think the analogy of, we have many different plans that are out there.

Senator BAUCUS. Describe it apart from the labels. Is that generally how it works?

Mr. GOSS. I think you described generally how it works, Senator Baucus, if I might just correct one point on it about the point of ownership. The nature of the sort of offsets that are set up in Commission Model 2 are such that the intent is that individual account money that would be put into people's accounts would, in fact, be there and that they would enjoy the entirety of the money that came from that. But there would then be an offset compensating for the value against their benefits.

Senator BAUCUS. Which is, in effect, the principal.

Mr. GOSS. Which, in effect, is the principal plus the 2 percent annual "interest."

Senator BAUCUS. Plus the 2 percent. Correct. The benefits will be reduced by the amount of the principal, plus 2 percent per year.

Mr. GOSS. That is right. And the hope and the expectation is, of course, that people——

Senator BAUCUS. The benefits would, in most cases, be less than what would be the case if you receive only Social Security benefits under the current law. That is, relative the scheduled benefits.

Mr. GOSS. The scheduled benefits?

Senator BAUCUS. Yes. In most cases.

Mr. GOSS. In most cases, for some period of time we project that with expected returns for individual accounts, total payments would be perhaps somewhat higher. But it would be very close and ultimately it would fall below.

Senator BAUCUS. In most cases, take an average income person who retires, say, 30 years from now. That person's net—net—that is, his reduction of Social Security benefits, plus his further reduction of Social Security benefits because the principal and the 2 percent was not subtracted, will be less than what that person would receive as scheduled benefits today.

Mr. GOSS. Less than they would receive under scheduled benefits.

Senator BAUCUS. Which is the law today.

Mr. GOSS. Which is the law.

Senator BAUCUS. Up through 2040.

Mr. GOSS. Part way to 2042. Of course, there is also the question relative to the payable benefits when we reach the point where we can only pay 73 percent.

Senator BAUCUS. But I am saying, just relative to the scheduled benefits.

Mr. GOSS. Relative to the scheduled benefits, the numbers do fall below that level, no question.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Thomas, then Senator Conrad.

Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman. Thank you, gentlemen.

Just to kind of get a clear idea, just into the fund, I'm told that either a 1.89 percent increase on the payment or a 13 percent reduction in the benefits would allow the fund to last for 75 years. Is that basically right?

Mr. GOSS. In fact, if you could express the 1.89 percent a little differently, I believe in the trustees' report we indicate that if the tax income to the program over the next 75 years were increased by about 15 percent, then that would be sufficient to keep the trust funds in solvency throughout the period.

Now, the question is timing. Timing really matters. If we raise it by 15 percent in 2004 and for all years thereafter by this 1.89 percentage point increase in the tax rate, it will create this phenomenon of having the trust funds rise very rapidly and then come down at the end, much as occurred as a result of the 1983 amendments to Social Security.

If, however, we generate over the next 75 years a 15 percent increase in tax revenue by having the tax revenue come in on a gradually increasing basis so that we have relatively less now and have more coming in later, and had tax rates rising more towards the end, then we could put the system on a sustainable solvency path.

It is exactly the same with respect to the benefits. If we simply reduce benefits by 13 percent right now throughout the period, that would give us enough money. It would cause the trust funds to build and we would have enough to carry it through 75 years on the basis that Doug described.

However, at the end of the period we would not be on a sustainable path because, in fact, what we are projecting is that the benefits would have to be reduced then by a total of about 32 percent relative to those benefit levels scheduled in current law to be sustainable.

So, that would carry us for 75 years, but again, the timing counts. How we get a 13 percent benefit reduction, you would have to have that occur largely towards the end of the period in order to have it match up with the timing of the shortfalls.

Senator THOMAS. I guess that follows this idea that, well, there is no hurry. There is no crisis. What does close timing have to do with the movement here? If we put it off for 5 years, does that make a good deal of difference? Should we be doing something immediately to have to do less?

Dr. HOLTZ-EAKIN. I would say, from a budgetary perspective, it is easy to get a sense of that by thinking of the extremes. Do nothing. If one does nothing, you can hold the current program harmless with increasing transfers from the remainder of the Federal budget over the foreseeable future.

That simply generates enormous difficulties making decisions elsewhere. So timing, in many ways, is driven by the interaction of the need for the Social Security with the remainder of the budget in a situation where we have other great budgetary demands on the horizon. How quickly Congress wants to settle that for the long term will be their decision.

But, as Steve said at the beginning, moving sooner has great advantages: beneficiaries can adjust and Congress can adjust.

Senator THOMAS. This is simple and I guess I should know, but does the trust fund now receive interest on the money that is in the IOUs?

Mr. GOSS. Yes, it does. It is credited interest on the bonds. Special issue bonds are——

Senator THOMAS. They do not need any cash. It is just credited benefits. Is that right?

Mr. GOSS. It is credited much as if any of us had a bank account and we would be credited interest. The cash becomes available when the trust fund actually needs to redeem bonds.

Senator THOMAS. So there is no money flowing in from this interest.

Mr. GOSS. It is much as a bank account would be for any of us. It is an electronic transaction.

Senator THOMAS. Is it or is it not flowing in? It is not?

Mr. GOSS. It is not literally flowing in in dollars, no.

Senator THOMAS. All right.

The personal accounts. I mean, the private, personal accounts. Over a long period of time, the reduction in revenue would be offset by the reduction in benefits. But in the meantime, I guess, the cash flow would be affected. Is that true?

Mr. GOSS. Absolutely. Yes.

Senator THOMAS. And that is one of the problems in terms of reducing the amount paid in income.

Mr. GOSS. Yes.

Senator THOMAS. You can offset that in the short run.

Mr. GOSS. And if I might add, and Doug, I think, spoke to this perfectly earlier, if you were going to move the system more towards having some advance funding, whether done through individual accounts or through other means, like increasing the money going to the trust funds themselves, one of the costs, the price you have to pay to create more advanced funding, is to come up with some additional money for a period of time so that you can build up that advance funding.

That is exactly what happens in the individual account proposals we are dealing with. In order to create this advance funding, to have these individual accounts build up, additional money becomes necessary.

It is sometimes referred to as a transition cost, a transition investment. It is handled in many proposals by having some additional general fund transfers made available to the system to allow it to put these monies into individual accounts, but that is basically the mechanism.

Senator THOMAS. Thank you.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. I thank the witnesses as well.

We have had some talk here about how what the President's Social Security Commission talked about as Option 2 would affect the budget. I asked the Budget Committee staff to do an analysis of that. Maybe we could put up a visual here.

This is one of the issues that concerns me a great deal. Going back to 2 years before 2000 in this chart, going forward by 5 years after 2000, from 1995 to 2015, a 20-year look at the budget. For a number of years we had surpluses. We actually were not using Social Security funds for other purposes for 2 years. We stopped that practice of, in effect, raiding the Social Security trust fund.

Now we have gone back into deficit in a significant way. If you add back to things that you see in terms of work cost, the President's additional tax proposals, military build-up, fixing the Alternative Minimum Tax, the red part of this graph is what we see as deficits going forward.

This part of it that has the dotted red lines is the increased borrowing, the increased deficit that would be created if we were to borrow the money to start these private accounts.

Is that an accurate depiction of what happens to the budget if the money has to be borrowed?

Dr. HOLTZ-EAKIN. Qualitatively, it must be, yes. I do not know the numbers.

Senator CONRAD. Well, the great concern I have is that it makes our fiscal situation worse, and it makes it worse for a considerable period here. The hope is that, by making this bet, that it is going to be better. It is going to be less of a problem later on. That is the fundamental concept here, that it is going to reduce demands on Social Security in the future.

That is an assumption. Here is the question that I am left with. What happens after 30 years of this program? Some people will do better than expected in terms of rate of return on investments, some people will do much worse. That is inevitable. The stock markets go up, the stock markets go down.

I remember very well what happened to my stock market portfolio 2 years ago. It was not pretty. As so many people have said, our 401s get turned into 201s. If one would have retired at that point and a substantial part of your retirement were based on these funds, you would have had a much lower standard of living.

But what is likely to occur, I think one of the questions we have got to ask ourselves, is if people have done less well, will there not be enormous pressure on Congress to make up the difference to those people?

That is not an academic question, because we have seen this happen in other countries that have pursued this approach, that is, Chile and Argentina. Both of those countries have found that if the stock market investments do not work out so well for vast numbers of people, their expectations are disappointed, those people come right to the lawmaking bodies and say, hey, wait a minute. You guys put this plan together. It is not working. We are going to be in poverty. You have got to make up the difference.

Mr. Goss, have you studied other countries that have pursued this approach, and have they run into difficulty when stock market returns have not met expectations?

Mr. GOSS. I wish I could say I had studied it well enough to answer your question with certainty. I do know that, clearly, there have been issues in the United Kingdom, in Chile, and many other countries in making a transition to this kind of an advance-funded system. But if I might suggest, I think what you are referring to here is the kind of variation that might occur in the future.

There are two kinds of variation. One, is if the fundamental returns for everybody, for the economy, do not turn out as well as we might hope or expect, that is one issue. Another point that I think you are talking about is the variation that might occur across individuals by pursuing different investment choices.

And it is true that that is, and should be, a concern for a proposal of this type. Some of the proposals have included certain kinds of guarantees that will say that people will not get less than a certain level, others have not included that.

Senator CONRAD. Let me ask you this, if I could. My time is about to run out. What are you projecting the economic growth rate for the economy to be over the next 75 years, in your projections?

Mr. GOSS. We are projecting that the growth in the economy will operate at a 1.6 percent real productivity growth rate per hour worked, and that the aggregate growth in Gross Domestic Product will, in fact, slow down from what we have been used to in the past simply because the number of workers—because of the low fertility rates, the low birth rates—in the population will be growing much more slowly, at about two-tenths of 1 percent per year rather than 2 or 3 percent.

Senator CONRAD. So you are estimating 1.8 percent.

Mr. GOSS. 1.8 percent.

Senator CONRAD. And what was the gross rate for the last 75 years?

Mr. GOSS. It was probably around, or maybe even in excess, of 3 percent.

Senator CONRAD. 3.4 percent, I think. My time has expired.

Mr. GOSS. And, of course, the reason for that is because, in our projections, of the very slow growth rate and the working-age population.

Senator CONRAD. Thank you.

The CHAIRMAN. The next three to four will be: Bingaman, Wyden, Schumer, and Bunning. Any person can use any plan that they want to to ask questions. So what I am going to say about Model 2 or Plan 2 is, there was not any inference that this was the President's plan, but remember that the President has not announced the plan.

In fact, every meeting I have had with him at the White House, it seems like he is going to give considerable thought before he does put a plan on the table. So, for Plan 2, any reference to the President having this plan would be pure speculation, at least from everything I know about what he is thinking about doing.

You are next, Senator.

Senator BINGAMAN. Thank you very much, Mr.Chairman.

Let me ask Mr. Holtz-Eakin, if I could. As I understood it, CBO's estimate for the outlays versus revenues in Social Security, the estimate was that outlays would continue to be less than revenues until 2018. That was last week. This week, it is 2020. Why did you change that by 2 years?

Dr. HOLTZ-EAKIN. It actually changed 1 year. It used to go negative in 2019, now it goes negative in 2020. If you look underneath that headline, you will find this is a tiny change. It is essentially noise and does not involve any fundamental reevaluation for the program.

Senator BINGAMAN. So you can get a tiny change that is essentially noise and it will change that by 1 year. I guess that I am just trying to project forward 75 years. I notice that the trust officers for Social Security estimate that they will be unable to pay full benefits in 2042, and you say 2052. Could you just explain that decade? Is that also noise?

Dr. HOLTZ-EAKIN. That is largely differences in economic assumptions. We assume long-term interest rates will be 3.3 percent, adjusted for inflation, and SSA, 3 percent. So if you put a dollar in a trust fund, we give you more interest than they do and the trust fund lasts longer. We also have a little bit lower benefits going out, so it lasts longer. This is the nature of making long-term projections.

Senator BINGAMAN. Well, taking that into account, I am just trying to put this whole thing in perspective. The figure is, if we do nothing, Social Security will have a shortfall of $3.7 billion in the next 75 years.

Mr. GOSS. Trillion.

Senator BINGAMAN. Trillion. Excuse me. $3.7 trillion. Do we have an estimate, Dr. Holtz-Eakin, on what the shortfall in Medicare will be over that 75 years if we change nothing?

Dr. HOLTZ-EAKIN. If we change nothing, I do not know how to calculate that shortfall. It grows so rapidly, that discounting it back to a single number is a very dicey proposition. On current track, Medicare and Medicaid could rise to be as large as the entire Federal Government in the next 50 years. Going past 50 to 75, that growth rate is very big.

Senator BINGAMAN. So if we were to do an apples-to-apples comparison and say we want to know the shortfall in Social Security, we think it is $3.7 trillion, let us see what this shortfall in Medicare is for the 75 years, it would be substantially greater. Is that fair?

Dr. HOLTZ-EAKIN. The demands for spending will be much greater in Medicare. Recall, Medicare uses a lot of general revenue, so the shortfall concept is a bit slippery in these circumstances.

Senator BINGAMAN. It is a shortfall in the Federal budget somewhere.

Dr. HOLTZ-EAKIN. Yes.

Senator BINGAMAN. Do you have an estimate as to the shortfall over the next 75 years for making the President's tax cuts permanent?

Dr. HOLTZ-EAKIN. We have not done that calculation. The closest thing is in our most recent budget outlook. At the end of the 10-year window, it is a little under 2 percentage points of GDP. You can imagine that being roughly an index of this size going forward.

Senator BINGAMAN. The figure I was given was that the shortfall for making the tax cuts permanent over the 75 years would be about 5 times the shortfall from Social Security. Is that reasonably accurate?

Dr. HOLTZ-EAKIN. Well, in our chart, the difference between benefits at the top and revenues at the bottom are about 2 percentage points of GDP. So, those numbers look closer to the same than 5 times different.

Senator BINGAMAN. Oh. All right. So you think it is more that they are comparable. All right.

Let me just ask about this issue that Senator Conrad was talking about, the Social Security trustees. Could you be a little more specific about why you are so pessimistic about future growth here in the country? Are you suggesting that it will be about half the rate over the next 75 years than it has been over the last 75 years?

That is much different than what we politicians like to tell our constituents. I mean, we are telling them we are moving on to the high summit uplands here, and you are telling us that you think this country is going to be growing about 20 percent as much as China, for example, each year.

Mr. GOSS. Yes. Senator Bingaman, this is not really only just a matter of the aggregate size of the economy growing at a slower rate, but in fact the working age population will be growing at a slower rate. That really is the determining factor.

Each worker in the economy can only produce so much, and if the number of workers will be growing at a slower rate in the future, then the overall output or the overall amount of goods and services they produce will be growing also at a slower rate.

If we could get them to be more and more productive over time, and we are always trying to do that, then we could recapture some of this. But we have always been trying to increase.

Senator BINGAMAN. Is it fair to say that if people are staying in the workforce longer or more immigrants come in, all of those factors would make your projection too pessimistic and therefore the shortfall in Social Security substantially less? Is that fair?

Mr. GOSS. You are exactly right. Our trustees do have a set of assumptions they believe are most likely. But with alternative assumptions—and we do do sensitivity analyses for all of our work—if immigration is higher, if people work longer, stay in the labor force longer, those would be very much pluses in terms of helping to solve some of the shortfalls for Social Security.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Thank you.

Now, Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Gentlemen, both of you have been very helpful. It seems to me you have laid out that Social Security has real challenges. Unquestionably, the demographics are relentless: we are going to have more older people retiring, we are going to have fewer younger people working.

At the same time, it seems to me that you have not laid out a Chicken Little scenario, that western civilization is going to end in the next few minutes, so there is a chance to do this in a thoughtful kind of way.

I want to start by asking you, what is different between this period and what the country faced in 1983?

In 1983, of course, the Congress came together in a bipartisan way with the administration. The demographics, it seems to me, were fairly similar.

But without this level of polarization, it seems to me there was a bipartisan effort to come up with the plan. Frankly, if Social Security had not been frittered away on a variety of other programs, we would not have some of the problems we have today.

My question is to both of you, what is different between now and 1983, in your mind, or is it a fairly similar situation? Why do we not start with you, Mr. Goss?

Mr. GOSS. Well, for better or for worse, I was here in 1983, working in this office, and did see what was going on. I think a principal difference, at least superficially, that we know was going on at that time was that the trust fund exhaustion, as I believe Senator Baucus mentioned earlier, was very close on the horizon. That was certainly a motivating factor.

But the other motivating factor, to not only just fix the very near term but to go well beyond that at that time, to fix long-term problems that did, indeed, extend the solvency through what was expected to be 75 years from that point in time, were the realities of seeing what population trends and other trends in the population and economy were likely to be.

They took very strong steps, very important steps that have really bolstered the solvency of Social Security to the point where you have it now. So, I think they had two motivations. One was the truly immediate problem of making sure that Social Security would pay benefits in the very near term.

That could have been done with rather small measures. They took much larger measures looking at the longer time frame and the larger problems down the road and they took a good step in the direction of fixing those.

Senator WYDEN. But they clearly stayed within the existing structure and something that has been in place for decades, and to deal with something that, by all practical calculations, you have even said, was much more immediate. So what is odd is, why would something be further down the road when you cannot find some common ground without this level of polarization that we had in 1983.

Do you want to get into this, Dr. Holtz-Eakin?

Dr. HOLTZ-EAKIN. I think there are four differences. The first is, I was not here. [Laughter.] Second, is that we are 20 years closer to the retirement of the baby boom generation and 20 years closer to the shift in the demography of the United States, so there is less time.

The third, I would say, is that we are steering much more clearly in the face of rising health care costs and their implications in the Federal budget in these health programs, Medicare and Medicaid, which likely make the current fiscal situation as a whole unsustainable.

The fourth is that we are building on an economy at this point which is, in fact, in very good shape. In 1983, there were enormous concerns about the future of U.S. economic growth. We have had good productivity growth. We continue to have good productivity growth. So we can, as long as we do not actively do something destructive, count on that as a benchmark off which to build any solution.

Senator WYDEN. I think your point about health care is particularly telling. It is obvious to me that medical costs are gobbling up everything in sight. Senator Hatch and I have put in place a comprehensive effort to deal with it, and you all have been helpful in that regard. But, again, that makes the argument for going after health care immediately and putting Social Security next in the queue.

One of the things I am going to try to do in these hearings, and why I think it is helpful to have you two particularly, is to look at ideas that can lead to an effort to reach some common ground, and that is why I am asking about some ideas that have been really brought to me.

One that comes up from constituents constantly is, what would be the financial implications, say, of having individuals who are extremely affluent simply not part of the program? If we look at Social Security, we want it to be a social insurance program. We want it to be there for working families and seniors.

But let us just say that people of great affluence, people with Donald Trump type fortunes, let us say people who make several hundred thousand dollars a year, just hypothetically, maybe $250,000 a year, Dr. Holtz-Eakin, have you all looked at some of the implications of saying that those people simply would not receive Social Security checks?

Dr. HOLTZ-EAKIN. We have not priced out a whole proposal. We did take a quick look, a couple of years ago. Individuals of that income were receiving about $5 billion a year in benefits.

So, you could imagine, that is a starting point for the magnitude of the implication if we just did not pay those benefits. They also paid taxes on those benefits and they paid taxes over the course of their career, so you do have to sort it all out.

Senator WYDEN. So if you said, over a 30-year period, people like that would not receive a check, you would be talking about $150 billion. That is obviously a small part of any solution, but certainly $150 billion is something worth contemplating.

Senator HATCH. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you, Senator Grassley and Senator Baucus, for having his hearing. I know my time is limited. I want to make a brief statement and then turn with some related questions to the witnesses.

I think every member of this committee knows that Social Security is a success story, but every member here also knows that the program needs some changes in order to make sure it is there for future generations of Americans.

The question we have to wrestle with is, what sort of changes? Does the program need minor tweaking or does it need, in effect, to be dismantled and replaced with something else?

Almost all of us on the Democratic side believe that the President's plan to partially privatize the system is a bad idea from the start, whether you call it privatization, personalization, or whatever the buzz word happens to be this week.

We have come to this conclusion not because we believe the government does everything right, but because we believe the President's solution is fundamentally flawed.

Ironically, it makes the underlying problem of restoring long-term solvency not less difficult to solve, but more difficult to solve by taking money out of the program at exactly the wrong time.

In addition, siphoning payroll tax money into private accounts will add trillions in additional debt that future generations will have to repay, and that is unacceptable.

Unfortunately, on this issue of Social Security, the President, I think, is being advised by some idealogues who almost have this passionate belief to show that government cannot do anything well and the private market always does things better.

In my view, and in the view of most of my colleagues and I think most Americans, he is getting bad advice. The President needs to decide whether he wants to take the lead in fixing Social Security or whether he wants to take the lead in, in effect, destroying the most successful social program in history.

I want to bring some additional focus on the debt issue, which I will ask you questions about. It has not received much attention so far.

If you take a look at this chart here, you will see that the per capita public debt, the amount owed by every man, woman and child in this country, was just under $12,000 in 2001. Call this the birth tax, since it is money that each newborn American will have to pay back with interest, and so will each of the rest of us, too.

When President Bush took office, the number was on the way down. As a result of the President's tax cuts, September 11th, the slowed economy, our fiscal situation has shifted 180 degrees. The per capita birth tax is now scheduled to grow to over $18,000 by 2015, even if we do not do any other changes.

When you add in the defense build-up, the ongoing cost of the war in Iraq, and the cost to make all of the President's tax cuts permanent, you get to $25,000. Here is where another major problem for privatization lies.

According to most estimates, setting aside 4 percentage points of the 12.4 percent Social Security tax for private accounts would require the government to borrow close to $2 trillion over the next 10 years to pay the benefits.

Adding this borrowing to the other policies would make the death tax $30,000. That means every child born in America will be $30,000 in debt on the day they were born. This number does not include any reforms to the AMT or the debt service costs.

Now, we talk about moral issues around here. For many, this is a moral issue. The Social Security reform plan is a non-starter not only because privatization makes the program worse, but because we find these levels of debt unacceptable, unsustainable, and not representative of our values.

Simply put, it is immoral to borrow another $2 trillion from future generations to finance Social Security reform, and we have to find a better solution than that.

Now, my questions relate to that. First, for Dr. Holtz-Eakin. Let me follow up on the issue of debts and deficit. One of the things that all of us have learned in basic economics is that a large deficit can have a number of negative economic effects. We have heard how they can lead to higher interest rates, but could you elaborate on how such debt impacts the trade deficit, the value of the dollar, and other factors?

Dr. HOLTZ-EAKIN. The typical deficit is borrowing to spend now. As a result, you save less as a Nation and you grow slower in the future. If you save less and you continue to do investment, you have to borrow from overseas. It is the case that this decision to save less as a Nation has long-run and short-run economic implications. It can show up in interest rates, exchange rates, and things like that.

A distinction that is important here is that the typical deficit involves borrowing to spend it. If one were to borrow and put the money immediately into an individual account, you would by definition borrow and save it, so the first order effect, from a national perspective, would be a wash. What would be important thereafter is how both the government and the individual reacted to that, whether they saved more or less.

Senator SCHUMER. And how do you think they would react?

Dr. HOLTZ-EAKIN. You can be the expert on how the government reacts to that. Individuals have to evaluate that additional accumulation in an individual account and whatever goes on to the remainder of the Social Security program. To the extent that you change the underlying program, that will interact. If you just give them the money and they feel better off, they will spend more. They will not save.

Senator SCHUMER. Right.

Dr. HOLTZ-EAKIN. If the program is changed simultaneously, it will depend on how much they——

Senator SCHUMER. And let me ask you this.

Senator HATCH. Senator, your time is up.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Gentlemen, you both have been around long enough to realize that the Social Security trust funds have been used by the government for other purposes since Social Security was begun in 1937.

The crisis occurred in 1983 because of that fact. We ran out of money. That was the crisis. We could not pay a benefit 2 months down the road because there was no money in the fund. Is that incorrect?

Mr. GOSS. Senator Bunning, what actually happened as we led up toward 1983, was that, in fact, we did have a period of time for some years prior to 1983 where we were, in fact, actually redeeming the bonds in the fund and we were using those. The government did, of course, back them with full faith and credit, but we did reach the point where we had used up all of those bonds.

Senator BUNNING. And the solution in 1983 that we heard talked about, it is easy to increase taxes and reduce benefits. We do not even think about doing that right now. That is off the table, increasing taxes and reducing benefits.

None of my colleagues on the other side of the aisle are even thinking about a solution to the Social Security problems that involves increasing payroll taxes and reducing benefits down the road as a solution like the Greenspan Commission and the Bipartisan Commission did in 1983. That is how they solved the problem in 1983. You are the one that was there.

Mr. GOSS. Exactly, yes. That is how they solved the problem, a combination of additional revenue and a reduction in benefits.

Senator BUNNING. And it was a patch. You said it was a long-term solution. Did they forget about the baby boomers?

Mr. GOSS. No. No, they did not. They did make, in effect, a down payment on fixing that problem.

Senator BUNNING. A down payment.

Mr. GOSS. When the trust funds were expected to be exhausted almost immediately in 1983, to extend it out to the mid-2050s was a very big extension. The thing that was not paid full attention to at the time was what we have tried to describe as this concept of sustainable solvency, because even at that time the trust funds were projected to go up and to be dropping rapidly at the end.

Senator BUNNING. Yes. I have a chart that shows just that.

Mr. GOSS. Exactly. We are hoping to avoid that in the future.

Senator BUNNING. Well, you realize, though, whenever the inflows of Social Security money do not produce enough money for the outflows for benefits, that making those bonds good is going to have to come out of the hide of our general fund, so that means we are going to be able to spend less on other things, or raise taxes, or do something to produce enough revenue to redeem those bonds and the interest associated for those bonds. Is that correct?

Mr. GOSS. You said it better than I tried to.

Senator BUNNING. All right.

Dr. HOLTZ-EAKIN. Senator Bunning, if I might just add to that. I think what you are pointing to is, at any given point in time, whatever the cost of providing benefits is, is the cost that has to be met. If there are sufficient specified payroll taxes to meet that, fine. If there is not, then the cost would be met in some other form, or not.

In the case where we have trust fund money that can be redeemed, then those trust fund redemptions can pay the rest. But you are exactly right. That money has to come from somewhere.

Senator BUNNING. But we are talking about 13, 14, or 15 years down the road where the inflows do not meet the out-goes. Is that about right?

Dr. HOLTZ-EAKIN. About right, yes.

Senator BUNNING. All right.

Then there is a difference of opinion between you two, or your agencies, on when, in fact, the law dictating how many dollars are paid to beneficiaries is met, 2042 or 2052. What is the reduction in benefits at that time according to the law?

Dr. HOLTZ-EAKIN. Our estimate is 22 percent.

Senator BUNNING. Twenty-two percent.

Mr. GOSS. Our estimate for 2042 is that it would be a 27 percent reduction.

Senator BUNNING. All right.

So, in fact, we do have a problem in how we meet the problem, and the immediacy of the problem, and how many dollars we spend on the problem is to be determined. I do not believe the President has put forth a plan yet. I know Chairman Grassley has not put forth one.

A couple of us younger people have put forth plans, but those are not fixed in stone. We put those forward to advance the cause that

Social Security has a problem. Somebody mentioned the thrift plan. I do not think the thrift plan has been in trouble since we started it.

Senator HATCH. Senator, your time is up.

Senator Santorum?

Senator SANTORUM. Thank you, Mr. Chairman.

I would like to pursue Senator Wyden and Senator Bunning's questions on, what is the difference between now and 1983. In 1983, we were at the point of trust fund exhaustion and we basically really did not act aggressively to deal with that before, and so we were left with two choices. Those two choices were exercised: one was to raise taxes almost 20 years, and two was to cut benefits, including raising the retirement age by 2 years.

Now, I suspect that if we reach the point of trust fund exhaustion, if that is the point that everyone wants to make, we would be left with two choices. That is, to increase taxes or to cut benefits. Is that correct?

Mr. GOSS. Yes.

Senator SANTORUM. So what we are attempting to do is put a third option on the table, and that is something that is done in a lot of retirement systems, and that is to pre-fund your liability.

In other words, to put some money aside now in savings and use that savings and investment over time and the power of the American economy in a rather—at least from everything that has been introduced here in the Congress—controlled setting of index funds that would be rather limited in nature, to put that savings and faith in the American economy over time and use that to help reduce the long-term shortfalls in the program. Is that an accurate way of describing what these plans are about?

Dr. HOLTZ-EAKIN. They are certainly about pre-funding Social Security instead of doing it on a pay-as-you-go basis.

Senator SANTORUM. And so the idea that we can wait to solve this problem, if we waited 40 years, could we pre-fund or have a third option available or would we be stuck with tax increases and benefit cuts? Is there any other way to solve the problem if we do not pre-fund the benefits?

Dr. HOLTZ-EAKIN. We would at that point, for the immediate needs of the trust funds, have to act rapidly, as in 1983. Advance funding would still be possible on top of that, of course.

Senator SANTORUM. For long-term.

Dr. HOLTZ-EAKIN. For future periods. It is always for future periods.

Senator SANTORUM. It is always for future periods. So the idea of waiting basically precludes any kind of long-term, sustainable pre-funding of our liability.

Now, the other question I had is, why now as opposed to waiting until exhaustion? Can we look at the deficit projections? You guys do deficit projections. If you look at deficit projections in 2040, what percentage of GDP are we going to be looking at as far as a deficit is concerned versus today's deficit projections, given where we are budget-wise today?

Dr. HOLTZ-EAKIN. The wild card is how fast are Medicare and Medicaid growth. Suppose the good news thing happens and they only triple in size to 12 percent of GDP, Social Security is 6 percent of GDP, but you are at 18 percent. The traditional level of Federal revenues is a fraction of GDP, and you still have not touched the rest of the government. You could also have more revenues coming in.

Senator SANTORUM. So your point is, given what the general level of taxation is and the general level of government spending, we are in much better shape to borrow today than we would be to borrow 40 years from now. Is that correct?

Dr. HOLTZ-EAKIN. I would say it more starkly. It is unlikely that the current path of the Federal budget can survive for 40 years.

Senator SANTORUM. So the idea of pre-funding our liability, when we know we have these huge potential liabilities laying out there, and Social Security being one of them, actually pre-funding that now, even though we have relatively high numeric deficits, compared to the future, they are going to be relatively minor compared to the problems we are facing in the future. Is that a fair characterization of our deficit picture?

Dr. HOLTZ-EAKIN. That is a fair characterization of our deficit picture. The big difference between now and 40 years from now is, 40 years from now the baby boom will have retired and will be permanently older.

So the policy problem, which is really two parts, the baby boom retires and we become older, and then longevity causes things to drift along, the first part will be done, and it will be a different world.

Senator SANTORUM. So, everyone talks about the concern about incurring some borrowing now and how it would impact the economy. What is your sense that if we had to borrow, let us say, $100 billion a year in additional borrowing, and that money was invested—of course, some of that investment would be in bonds, some of them government bonds, so that would clearly just be a wash. I mean, it would be personally-held debt as opposed to Social Security-held debt. What would be the impact on interest rates, do you think, if we had $100 billion a year in additional borrowing, or $150 billion?

Dr. HOLTZ-EAKIN. If it was just borrow investment accounts, you could borrow with Treasuries, invest in Treasuries. It would be a wash. You could then take on more risk and hope for higher rates of return. As I said earlier, the initial impact is a wash from a national saving point of view.

The important thing is to not look at that piece alone, but look at whatever is done in its comprehensive nature and see whether it raises national saving in aggregate as opposed to the little pieces on the government budget or on the individual's budget.

Senator SANTORUM. I respect that. But my sense is, what you are telling me is that you do not see a dramatic impact on interest rates if we were to do a personal account if that money were to be put into net savings.

Dr. HOLTZ-EAKIN. I am just being careful to make sure that something else is going on to make sure that we are still saving.

Senator SANTORUM. I accept that. I see my time is almost out. I just want to say that I am doing my part. I have six children. If you look at fertility rates as the problem, I just want to encourage others to do your part: to save Social Security, have children.

Mr. GOSS. We thank you, Senator Santorum.

The CHAIRMAN. Senator Smith is not here, so we will go to Senator Kerry.

Senator KERRY. We may have to create a few more jobs for those children, too.

I think that there is nobody on this side of the aisle, there is nobody in the Congress, who does not understand that Social Security has a long-term, as you called it, sustainable issue. We all understand that. But there ought to be three fundamental principles, I think, that guide us as we think about what we are going to do about it.

Senator Bunning should understand that each of us on this side of the aisle may not have considered his specific proposal to raise the payroll tax, which is the most regressive tax in America, but there are many other ways, are there not, to think about how you fill revenue gaps here or deal with benefits. Correct?

Mr. GOSS. Yes.

Senator KERRY. Now, in 1999, I think I had become an expert on things President Bush has said or not said. In the course of this campaign, he must have said 100,000 times that he wants to privatize accounts. Correct?

Dr. HOLTZ-EAKIN. I am not an expert in what he said.

Senator KERRY. He wants privatized accounts. And whether it is the 2 percent account you have or otherwise, it means shifting money out of Social Security into a private account, does it not?

Mr. GOSS. It seems to, yes.

Dr. HOLTZ-EAKIN. Yes.

Senator KERRY. Now, if you do that, let us say it is 2 percent. Two percent is not really the 2 percent everybody thinks of. It is 2 percent of the 12.4 percent, which is actually one-sixth. It is a big amount. So, that has a big effect which absolutely mandates, does it not, in terms of that $2 trillion borrowing, you will cut benefits. There will be a cut, a reduction in benefits under that plan.

Mr. GOSS. In the design of the plan, as we have looked at it and worked with other plans to take money out of the trust funds to create the individual accounts, typically you would have an offset against the remaining benefits in order to go forward.

Senator KERRY. The offset is either that you are going to cut the benefits or you are going to raise the revenue. He is not talking about raising revenue. You are going to cut the benefits, correct? That is the current plan. Yes or no?

Mr. GOSS. Yes.

Senator KERRY. Benefits will be cut. So America needs to understand, benefits are going to be cut, as we are currently looking at it.

Now, they are going to be cut to do what? To fix a problem based on differing assumptions. You do not even make assumptions about immigration adequately. I think America is going to continue to be a country with increased immigration, increased job growth, and so forth. That will change who the workforce is.

But let us go beyond that. The fact is, your own report, Dr. Holtz-Eakin, of the CBO suggests this is really a modest problem. I mean, is it not fair to say that a more immediate, significant challenge to us in terms of the deficit in America is Medicaid and Medicare?

Is it not more immediate?

Dr. HOLTZ-EAKIN. It happens sooner and gets larger.

Senator KERRY. So it is more immediate.

Dr. HOLTZ-EAKIN. Yes.

Senator KERRY. Yes or no?

Dr. HOLTZ-EAKIN. Yes.

Senator KERRY. All right.

Now, the fact is, your report says that to make the Social Security trust fund well into the 22nd century is fundamentally a modest problem that would require only additional revenues, at current benefits, of 0.54 percent of GDP. That is, less than 3 percent of Federal spending. It is less than we spend in Iraq. Accurate?

Dr. HOLTZ-EAKIN. That would be the actuarial imbalance as a fraction of GDP.

Senator KERRY. But accurate, what I just said. It is 0.54 percent. It is less than 3 percent of Federal spending. It is less than we spend in Iraq to make it well into the 22nd century. Correct?

Dr. HOLTZ-EAKIN. It would require, as well, transfers from the budget over a sustained period in order to make it well.

Senator KERRY. Correct, because we are taking money from one place to another. One of the places we take that money, because the money I just talked about to make Social Security well into the 22nd century is a fraction of the tax cut that President Bush is giving to the wealthiest people in America.

If people earning more than just $500,000 a year gave up their tax cut, we would make Social Security well without any cuts in benefits in the 22nd century. Is that correct, Mr. Goss?

Mr. GOSS. We have not run those numbers, but I understand from Doug, it sounds like it is about on target.

Senator KERRY. That is correct, is it not?

Dr. HOLTZ-EAKIN. All the tax cuts, including those which are in the 10 percent bracket and the other provisions, are a total of about 2 percentage points of GDP. That is the difference between benefits and revenues in——

Senator KERRY. That is a wordy way of saying, yes, it is correct.

Dr. HOLTZ-EAKIN. It is not just high-income people, sir. I want to be clear about that.

Senator KERRY. It is $500,000 and up, I am telling you.

Dr. HOLTZ-EAKIN. Our estimate of 2 percentage points of GDP is all of the tax provisions.

Senator KERRY. It is 3 percent of Federal spending. It is not all of the tax provisions.

Dr. HOLTZ-EAKIN. I know it is my number.

Senator KERRY. The bottom line is, that is a one for one.

So let me just make the point here that there are two issues, Mr. Chairman. You have got the question of how you fix Social Security for the long term, but then there is a completely separate issue, this private account deal. The private account deal does not make Social Security stronger or better.

If you were to have universal 401(k)s and a fairer way of encouraging savings for people in the middle class, you are saving at an upper level, you get 35 cents on the dollar you can deduct. You are saving at the lower level in America, you get 15 cents if you are in that bracket.

The point is, if we were to make a greater match, provide greater savings, we could increase savings in America, which this proposal does nothing to do, and we could provide greater wealth creation to the middle class of America, and we could make Social Security whole well into the next century without having this draconian benefit cut.

What the President is doing is a triumph of ideology over reason, it is a triumph, frankly, of political rhetoric over good legislation, and I think we are going to prove that over the course of these next weeks.

The CHAIRMAN. Thank you, Senator Kerry.

Now, Senator Hatch?

Senator HATCH. Well, Dr. Holtz-Eakin, in your testimony you mentioned the importance of the Social Security program to our economy, especially as to decisions individuals make about when to retire, how much they expect to receive in retirement benefits, how much they would save, and so forth. All of those are important.

What would be the overall effect to the economy and its growth potential if changes to Social Security were made that would encourage younger people to save more of their own money for retirement and that encouraged, but not forced, them to work longer before retiring?

Dr. HOLTZ-EAKIN. In aggregate, having more people working and having greater availability to finance the things they need to work with. Technologies and factories and things are beneficial to economic growth and would have that impact if that was the result.

Senator HATCH. So that would not be a bad idea if we could find some way of working that out, those two?

Dr. HOLTZ-EAKIN. Right.

Senator HATCH. All right. Well, I have to tell you, I am working on that.

What economic issues do you foresee as a result of the retirement of the huge baby boom generation? Will our economy be better off if workers were somehow encouraged to work until age 70 or beyond in 2040 or 2050 rather than retiring at the ages of 62 or 67?

Dr. HOLTZ-EAKIN. Well, as an economist, I can tell you that there is a distinction between making sure people work and getting more output and making sure they work voluntarily and are happy with that decision. Just simply making people work is not generally viewed as an improvement in performance.

But I think the general issue is that, as we move to an older population, those workers have skills and, to the extent that they wish to participate in the labor force, it will raise the size of the economies as a whole and raise the resources available for all needs, both the government and the private sector.

Senator HATCH. As a matter of fact, the life expectancy rate has been continually rising over the last 50 years. When Social Security first came out, it did not anticipate that people would be living the length of lives that they live today. Is that right?

Dr. HOLTZ-EAKIN. That is right.

Senator HATCH. Plus, our workforce is diminishing, unless we have illegal aliens fill the workforce for us, or new immigrants fill the workforce. Isn't that true, too?

Dr. HOLTZ-EAKIN. At the moment, the native population has fertility that is below replacement rates, so growth in the population, in the end, derives from immigration in the present, and the future.

Senator HATCH. And many people want to work beyond age 62 or age 67, and might very well be willing to work to have a higher standard of living and to be able to fulfill their particular goals and life's desires.

Dr. HOLTZ-EAKIN. There has certainly been a lot of discussion about the potential for the baby boomers, for example, who are living longer and are healthier, to work longer.

We did take a look at this at CBO. I will tell you that, at least looking at the behavior of the leading edge of the baby boom generation, those who are eligible to retire in 2008, there is no particular evidence that they are staying in the labor force longer than their parents. Indeed, at the moment it looks like they are departing at rates that are comparable, or faster, at earlier ages. So, it may yet happen, but not yet.

Senator HATCH. Because that is where the incentives are under the current system?

Dr. HOLTZ-EAKIN. Right.

Senator HATCH. Maybe the incentives need to be changed so the people will work longer and we have a better workforce in America, and we will have greater prosperity, a greater economy, and all the other benefits that come from people working.

Dr. HOLTZ-EAKIN. Yes.

Senator HATCH. All right.

Mr. Goss, some are saying that there is no problem with Social Security. I'm sure you have heard those comments, that there is no problem with Social Security for another 40 or 50 years.

Now, is it true that the retirement of millions of baby boomers has absolutely no impact on the situation facing taxpayers in the Federal Government until 40 or 50 years from now?

Mr. GOSS. Clearly, that is not true.

Senator HATCH. Clearly, it is not. Right?

Mr. GOSS. That is correct.

Senator HATCH. All right.

You were going to say?

Mr. GOSS. While 2042 is the year, and Doug has 2052 as the year in which trust funds would exhaust and we would simply not, under law, be able to pay the full benefits, it is true that prior to that time we will reach the point where the taxes dedicated to Social Security will be insufficient and we will have to go to the general fund of the Treasury to redeem the bonds.

Senator HATCH. The sooner we start to attack these problems, the better off, it seems to me, the economy is going to be over the long term. Would you agree with that?

Mr. GOSS. I think it depends on exactly what we do, but there is absolutely no question that——

Senator HATCH. But assuming we have a reasonably good approach, we would be better off to do it now than wait for 5, 10, 15 years?

Mr. GOSS. We certainly would hope that, if we do it the right way, there is no question.

Senator HATCH. Some people are saying that if we make a few changes, we can fix the system. What if we simply included State and local workers in Social Security, or increased the cap on taxable wages? Would that make the system sustainably solvent for good?

Mr. GOSS. They would, together, potentially fix perhaps about half of the 75-year problem and they would contribute somewhat less than that towards getting to sustainable solvency.

Senator HATCH. Well, personal savings accounts are something that I am very interested in because I believe, if we can get people to save and invest, they are going to be a lot better off in the future than if they wait for a system that clearly will break down every year if we do not grab the ball and do something about it now.

I am very concerned about it because, as you pointed out, we are going to have just two workers for every one retiree on Social Security.

My time is up. But we are just hurting the young people if we do not do something about it now and get this matter straightened out.

The CHAIRMAN. Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

I want to thank both of you. Certainly, it is welcome to begin a process of systematically analyzing all of the issues surrounding this fundamental question, particularly on a program that has worked exceptionally well for more than 70 years.

I happen to think that we just cannot rush pell mell into making any dramatic changes until we ascertain the nature of the problem, the level of urgency, and the dimensions and scope of the issues that we really have to analyze.

So, I hope that we do not rush to act or put this issue on a fast track for the sake of efficiency, because I truly do believe that this is a program that has worked not only very well for our seniors in this country, but it has also provided a level of stable income on a monthly basis.

I do not think there is any substitute for that, particularly in your retirement years. So, how we address the future issues, I think, really should be given the care and consideration that this issue deserves, and I really do think we have to exercise due diligence with respect to this question.

Now, I know that there have been intermediate, lower-cost assumptions and higher-cost assumptions with respect to making the projections for the future. In talking about 1983, and I happened to be in the House of Representatives at that time, I would characterize that more as a crisis because we were within weeks of insolvency. Some would say days, in fact.

It concerns me that we used different words like "crisis" and "bankrupt," because I do think it creates a level of fear among today's seniors about, something is going to happen with their current benefits.

How would you describe this problem that we are now facing as policymakers and those, as seniors, who depend on the current program? Would you describe it as a crisis?

Mr. GOSS. Are you asking me?

Senator SNOWE. Yes.

Mr. GOSS. Yes. We actuaries do our very best to try to avoid making these semantic distinctions and try to let the numbers speak for themselves. What we have laid out is, as I mentioned earlier, the fact that the current positive excess of taxes relative to the cost of the program will start to diminish in 2009, reach zero in 2018, and then we will reach the point where, after that, we will gradually use the monies available in the trust funds and reach exhaustion. "Crisis" is like "beauty is in the eyes of the beholder," and it may be seen differently from different points of view.

We do feel very strongly in our office, though, that the opportunities to make changes well before 2042, if taken, will leave us in a much better position to be able to come up with a solution that will give people plenty of advance notice and we will be able to phase in very gradually for people, which will be a very, very good thing.

Senator SNOWE. In the intermediate assumption, there are a number of ranges of possibilities in using different assumptions. If any one of those assumptions were to change dramatically, would it provide for 100 percent of the solvency of the program, whether it is economic growth, birth rates?

Some suggested that we ought to look at the dependency burden as another way of saying that, even though there will be fewer children, people will have fewer people to support. Do you buy that?

Mr. GOSS. Well, as I showed earlier, there is this concept of the aged dependency ratio, the number of elderly people in the population versus working age. Some people suggested you could look at what is sometimes called the total dependency ratio, where you would include not only the aged, but also young people, under 18, for example, and under 20, as part of the burden. One could look at that.

However, people do view sometimes separately the taxes they pay for Social Security and other aged programs versus what they pay more directly for their children. That is certainly a point of view.

Senator SNOWE. And I guess what I am getting at is, in these assumptions, these variables that are incorporated to make, in this case, an intermediate projection for the future, can any one of those issues change the numbers dramatically, including immigration?

As I understand it, there was considerable debate and discussion about the issue of immigration, whether or not it could have a substantial impact in the future or not. Could any one of those change it to lessen the problem or enhance the problem?

Mr. GOSS. We believe there is virtually no chance that any one of these particular parameters alone could make that kind of change. We do have under our low-cost scenario a scenario that indicated that if all of these parameters broke the right way and were significantly more favorable than what is thought to be the expected levels by the trustees, we can devise a scenario that would, in fact, turn out to be favorable and not require changes in the future. However, our stochastic analysis—and I think Doug's also—indicate that the probability of that likelihood occurring is very, very small.

Senator SNOWE. Now, how would you assess the actuarial whims of the stock market?

Mr. GOSS. The actuarial whims?

Senator SNOWE. That is right. Actuarially, how would you assess the whims of the stock market? I mean, in talking about diverting money from the payroll tax, because that is obviously a dramatic departure from the existing system. There is obviously a great deal of uncertainty. So, how would you assess that?

I mean, given the fact, just looking at September 11 and what happened after that dramatic and catastrophic event, I mean, the stock market declined and had its greatest single day of decline in the week after it reopened, I think, on September 17, and the greatest decline in that given week as well.

So, how would you factor that in? If this was to be something that we would have to achieve a higher rate of return, as I understand it, in diverting these personal savings accounts, you would have to also depend on foreign buyers of debt. Second, you would have to get a greater rate of return than what you get in Treasury securities and the current system. Is that correct? To make it work.

Mr. GOSS. Historically, clearly, stocks, equities, have had higher rates of returns than bonds. There is a question as to whether or not that should be fully expected and projected into the future.

Our view is that it is highly likely that stocks will, over long periods of time, have higher returns than bonds in the future, but there is much more volatility, much more variability in stocks, and that is something that absolutely has to be recognized.

One way that people sometimes do that, is to look at a risk adjusted analysis and, in effect, portray stocks as not really providing any higher returns than bonds.

Another way of doing it in a stochastic analysis or a variable scenario analysis where we say, yes, you probably have an expectation that stocks, on average, will provide a higher yield than bonds, but you have to keep very much in mind the higher volatility that is associated with that and be prepared for that.

Senator SNOWE. I just know, in reading a report, the equity prices, in fact, fell by one-third between 1999 and 2003, and they still remain, in many instances, below the 1999 level.

Mr. GOSS. That is true. But if I might just add, when we are looking over very long periods of time, which, generally speaking, if people start to invest in individual accounts, or if the trust fund, as has been considered from time to time, were to invest in equities, then we would be looking at longer timeframes, more than 2, or 3, or 5 years, and one would hope, as most people, when they are doing their retirement planning, that they will look over periods of decades rather than periods of a few years for their overall return.

Senator SNOWE. Yes. If you have those decades in retirement.

The CHAIRMAN. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, particularly for bringing us all here together to discuss a program that I think is very vital to our country. It is a vital safety net for our Nation's elderly, certainly, but sometimes we forget that it is also a safety net and an insurance program that our government provides for the sick, the widowed, and particularly the disabled, and has done so very well for the last 70 years or so.

So I am very proud of this program and what it has done. I come from a very old farming family in Arkansas, not unlike the Chairman, here. We are not a particularly wealthy farming family, Mr. Chairman, but we are an old one, with tremendous values that we learned growing up in a small community, and that was the importance of looking after our fellow man.

I think that this is a program where we as a Nation have been able to espouse the values, those very values of being able to look after our neighbors, those who are less fortunate, the widowed, the disabled, the sick, and certainly the elderly.

So, I hope that we will take the time, and I hope you gentlemen will hang with us for the long run here to provide and share your wisdom and help provide some of your proposed solutions so that we can really, truly make sure that this program continues to espouse the values that we as a Nation have in protecting and taking care of those individuals. I look forward to working with you, and we are grateful you are here today.

As I said, I am very proud of that program. But one thing I am not very proud of, is something I read in an article from this week's *Newsweek,* which basically mentions that home foreclosures have become commonplace in recent years as consumers have bought houses they could scarcely afford, they have taken out second mortgages on them to pay other bills, and bankruptcy filings are widespread as well. I know in our State we are seeing that. We are going to deal with that later on.

We have seen that savings rates have plummeted in the last 20 years here in our Nation. One study shows that the average American household has nearly triple the amount of credit card debt in this last decade. Our corporate citizens are not really that much different. They have joined the bandwagon. High-risk corporate debt rose to record levels last year.

I guess, really, in essence, we are changing our theory here in this country. I guess that is one of my biggest concerns. That is why I think we have two questions to answer here.

The two issues we really need to address in this debate are, number one, the solvency of a program that allows us to really reflect the values we have as Americans, a program that has done a good job at that, that is, the Social Security trust fund, and the second issue that we have in this debate is personal savings outside the current Social Security framework, actually, our attitude towards how we deal with the economics of our personal lives, our corporate lives, and certainly our government.

I think that is a critical part of this debate. I do not think one is going to solve the other, and I think we need to make sure that we maintain these two issues.

We have to be a Nation of savers, not borrowers. We must be a Nation that earns interest, and not pays it. I think that has become a huge issue for us.

I have to say that when I dropped my twin boys off at school this morning, I looked around at that playground and I saw their classmates, kindergartners, first graders, second graders, and I worry that their standard of living might suffer or be jeopardized because of the choices that we are making and the amount of debt that we are seeing.

So I hope, Mr. Chairman, we will, in the words of Senator Wyden, very thoughtfully look at what we have to deal with here and begin to come to some conclusions.

For the last 2 decades, we have borrowed from the Social Security trust fund and we have spent that money in the general fund, as people have mentioned here, approximately $1.5 trillion.

How do you think the government is going to pay that back, gentlemen?

Dr. HOLTZ-EAKIN. Arithmetically, it is real simple. To pay the benefits, we will have to cut spending elsewhere in the budget, raise taxes, or borrow it from the public.

Senator LINCOLN. If we borrow that money, then we are talking about increasing our debt, perhaps borrowing from other countries, which we have traditionally done. Are there other suggestions here of how we are going to deal with that debt?

Mr. GOSS. Well, we would increase the debt held by the public. Not the total debt that you deal with subject to limit, but the debt held by the public, absolutely.

Senator LINCOLN. And the concerns that we should have about that debt as it increases are?

Dr. HOLTZ-EAKIN. To the extent that larger Federal debt is reflective of lower national saving, then all of the concerns that I tried to express to other Senators would come into play. This leads to, other things being equal, lower accumulation of the means of economic growth that will slow down future standards of living.

Senator LINCOLN. And do you have any other options for dealing with those rising costs other than raising taxes, increasing borrowing, and cutting benefits?

Dr. HOLTZ-EAKIN. That exhausts the list of options.

Senator LINCOLN. So that is what we are dealing with.

As we have noted in what has been presented from the President's Commission, clearly in Model 2 the diversion of payroll revenues into individual accounts and the change in how that benefit is calculated are two suggestions that have been made in Plan 2.

The change from wage indexing to price indexing, you all have indicated, would lower monthly benefits, and that would be the real cause for those cuts. If we look at the numbers, 7 of the 10 States that are in the top 10 for the percentage of population over 65 are represented here. So, those who really would be devastated, in many instances, are represented here, our States are. We have a bigger proportion of elderly.

One of the things that I would also like to point out, is that Social Security is the primary source of income for two-thirds of the seniors and the only source of income for one-fifth of those seniors. So if we see the kind of cuts that are being talked about, do any of you all have the projections of the increase in terms of the number of seniors that would be living in poverty?

Dr. HOLTZ-EAKIN. I certainly think that the distribution across the population of the impacts of any reform are important, and we have worked hard to provide the information to the Congress. If there are details you would like, I would be happy to get them to you.

Senator LINCOLN. All right.

Senator SANTORUM. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Gentlemen, I just want to reconfirm a couple of points, as I understand Plan 2. Correct me if I am wrong. I know you will.

Is it not true that, generally, under Plan 2, looking at the fiscal problem facing the trust fund, the net present value, we are short about $3.7 trillion over the next 75 years. Is that accurate? We are short about $3.7 trillion.

Mr. GOSS. This is the shortfall for 75 years under current law.

Senator BAUCUS. Correct. Under current law, it is about $3.7 trillion.

That is basically paid for by a reduction in benefits through changing from wage indexing to price indexing, in round numbers. Is that correct?

Mr. GOSS. That is correct. As indicated even in the Commission's report, the first look the Commission did at their proposal Model 2 was to look just at the effect of the basic provisions.

Senator BAUCUS. Right.

Mr. GOSS. Which is basically the CPI indexing. That alone did, in fact, resolve the shortfall.

Senator BAUCUS. All right.

So that alone, just changing from price to wage indexing, essentially pays for the $3.7 trillion net present value.

Mr. GOSS. Correct.

Senator BAUCUS. All right.

Next point. Is it true that, under Plan 2, moving to a private account system, a partial private account system where a person can divert 2 percentage points from his payroll to his private account, that, first of all, does not solve the $3.7 trillion shortfall in the trust fund if we were not to reduce benefits?

Mr. GOSS. We have basically, under Commission Model 2, really two different ways in which benefits were modified. One is the CPI indexing, which would apply to all beneficiaries.

Senator BAUCUS. Right. Right. But I am just saying, if it is a $3.7 trillion shortfall, deficiency, whatever the word is, and if we do not change from wage indexing to price indexing, we still have the $3.7 trillion shortfall.

Mr. GOSS. That is correct.

Senator BAUCUS. But then allow 2 percentage points of the payroll tax to be diverted into private accounts, is it true that that would, first of all, not solve the problem, that is, $3.7 trillion, and second, it would add to the problem so the shortfall would be more than $3.7 trillion? Do you understand what I am trying to say?

Mr. GOSS. I think I do, exactly. I think a way to look at this, exactly in synch with what you are suggesting, is just what the Commission laid out. They laid out, right up front, that the basic changes—including CPI indexing—would in fact fix the $3.7 trillion shortfall.

Senator BAUCUS. Correct. But putting that aside.

Mr. GOSS. So that is taken care of.

Senator BAUCUS. No, no. I am asking a different question. Assuming we have current law. Just forget the cuts in benefits.

Mr. GOSS. All right.

Senator BAUCUS. So put that aside.

Mr. GOSS. The effect of the individual accounts then would be to, on the margin, have a slightly negative effect on the $3.7 trillion. The reason, of course, their motivation for doing that, is because of the opportunity through the individual accounts to backfill some of the reductions.

Senator BAUCUS. I understand that. But the point is, by diverting 2 percent, there is less going to the trust fund.

Mr. GOSS. That is correct.

Senator BAUCUS. It is not really a trust fund, but fewer credits going into the Social Security trust fund.

Mr. GOSS. Less revenue going to the trust funds. That, of course, is the offset to the benefits.

Senator BAUCUS. Forget the offsets. Even before the offset, my understanding is that it is about $4 trillion, the cost to the Social Security trust fund of the 2 percentage point payroll tax diversion.

Mr. GOSS. That should be about right. That should be about $4 trillion.

Senator BAUCUS. It is about $4 trillion.

Mr. GOSS. Of course, it is a package deal.

Senator BAUCUS. It is a package deal. But part of the package, then, is offset.

Mr. GOSS. The offsets.

Senator BAUCUS. Or the claw-back, whatever the term is. That is, roughly, close to $2 trillion?

Mr. GOSS. The offsets are probably something more like $2.5 trillion over the period.

Senator BAUCUS. All right.

Mr. GOSS. Of course, the difference between those is really, in fact, the cost of creating this advance funding mechanism.

Senator BAUCUS. Right. Right.

Mr. GOSS. And that, in fact, as you know, then, Senator, is met by the general fund transfers that are also a portion of this plan.

Senator BAUCUS. That is correct. So what I am trying to get at is, just so we understand what I am talking about here, the $3.7 trillion net present-value shortfall today under current law, under Plan 2, is paid for basically by moving from wage indexing to price indexing. But then in addition to that, part of Plan 2 would set up private accounts, which do not, by themselves, solve the current problem.

In fact, they make the current problem worse, to the tune of roughly $4 trillion on a gross basis. But then you would add in the offsets or the claw-back and that changes that gross down to between $1 and $2 trillion, the cost which, under Plan 2, is borrowed.

Mr. GOSS. Which is actually transferred to the trust funds from the general fund.

Senator BAUCUS. Then once it is transferred, we have got to make it up somehow.

Mr. GOSS. Yes. Yes. Exactly.

Senator BAUCUS. So in this case, we are talking about borrowing, unless we were to cut spending in that same period by that amount. Is that correct?

Mr. GOSS. But at the same time the government is borrowing, then of course there would be the creation of the individual accounts where there would be those assets possibly offset.

Senator BAUCUS. All right.

Now, is it also true that for those people under Plan 2 who do not want to participate in private accounts—I do not want to be part of this, I do not trust the stock market, somebody might think—is it also true that their benefits are going to be cut?

Mr. GOSS. Under Model 2?

Senator BAUCUS. Under Plan 2.

Mr. GOSS. That would be the case.

Senator BAUCUS. And cut by, off in future years, up to 45 percent compared with the scheduled.

Mr. GOSS. That is correct. I believe our estimate back 3 years ago was a 46 percent reduction in 2075.

Senator BAUCUS. So even if I do not want to participate in private accounts, holy mackerel, my benefits are going to be cut significantly under Plan 2. I am just trying to understand what Plan 2 is.

Dr. HOLTZ-EAKIN. Under Plan 2, I think it is fair to note that there is an unambiguous financial incentive to participate in the individual account, even if you just put it in Treasuries.

Senator BAUCUS. That is my point.

Dr. HOLTZ-EAKIN. It is unambiguous.

Senator BAUCUS. Why get a private account if it is all put in Treasuries, when it is in Treasuries as it is?

Which gets to my next point.

Dr. HOLTZ-EAKIN. We could discuss whether it is really in Treasuries.

Senator BAUCUS. My next point is, is it really pre-funding when you borrow this money? Because it is borrowed. In pension plans when you pre-fund, those are dollars that the company or the employee puts in of their own money. That is pre-funding. But when you put in all this up-front money and it is borrowed, that is not pre-funding, is it?

Dr. HOLTZ-EAKIN. The issue is to step back and look at the larger scope. We have a system which has been designed to be pay-as-you-go, and that requires current workers to pay for current retirees. If one wanted to move, in part or entirely, to a pre-funded system, those same workers would have to pay for their own retirement.

Senator BAUCUS. And they would have to pre-fund up front more.

Dr. HOLTZ-EAKIN. So the issue then is how to simultaneously pay for both of these retirements, in whole or in part, and who will bear the burden of that reduction in spending in order to do the funding. Using Federal debt to move some of that to the future shifts that burden down the line to some extent.

Senator BAUCUS. I understand. But that is not really pre-funding. Real, true pre-funding here would be if the employee were to pre-fund. I know it is pay-go.

Dr. HOLTZ-EAKIN. For pre-funded, it is who bears the burden of that.

Senator BAUCUS. I know. But pre-funding is commonly understood as the private sector, not big borrowing to pre-fund.

My time is way up. Thank you.

Senator SANTORUM. Yes, it is.

Let me just follow on this line of questioning for a moment. The money that would be going into this account is not the government's money. Is that correct? Whose money would be going into these accounts?

Dr. HOLTZ-EAKIN. All resources stem ultimately from the U.S. economy.

Senator SANTORUM. Well, obviously this is a deduction from someone's payroll.

Dr. HOLTZ-EAKIN. Payroll.

Senator SANTORUM. So it is not the government's money going into this account, it is individuals' money going into this account. Is that not correct?

Therefore, that is the only way to pre-fund, is to have individuals who, instead of paying taxes to the government, put money into their account. That is the funding mechanism, is it not?

Dr. HOLTZ-EAKIN. This is at the core issue of whether it is possible to pre-fund within the confines of the Federal budget or not. Individual accounts have the monies belonging to the individual. Attempting to pre-fund in the Federal Government has proven to be problematic, lock boxes, and the like.

Senator SANTORUM. Let us pursue that. One of the things that has been suggested is in the past we have pre-funded, through Social Security trust funds, the ability for us to pay benefits.

Have we pre-funded in our ability as a government to pay benefits through having higher taxes than we need to pay benefits? In our ability to pay the benefits.

Dr. HOLTZ-EAKIN. Paying benefits requires economic resources. The trust funds, per se, contain no economic resources. Ultimately, those benefits are paid for out of the budget and the economy as a whole.

Senator SANTORUM. And I would just suggest, Mr. Goss, you have used repeatedly the term "we used the money in the trust fund." Is there money in the trust fund to use when we pay those benefits after 13 years from now?

Mr. GOSS. There is certainly the commitment of the Federal Government to make it.

Senator SANTORUM. There is a commitment. But is there money in the trust fund?

Mr. GOSS. There are not literally dollar bills in the trust fund. However, if I might just make one point. That is that, during the years in which the trust funds were in fact building, the question that is on the table is, what exactly was happening with the rest of the economy? Was there, as a result of that, more saving than there might otherwise have been? Was there more investment elsewhere?

Were other taxes lower than they might otherwise have been because Social Security was running a surplus? If, in fact, that is the case, then there would be more savings and investment having occurred in the rest of the economy and we would have a higher base from which now to be able to redeem those bonds.

If, in fact, on the other hand there were not lower taxes elsewhere in the economy, and therefore not greater savings by the people in the country, then there would not be a greater wherewithal. Unfortunately, we do not have the ability really to determine which of these cases is true.

Senator SANTORUM. Let me ask you a question again, back to Senator Baucus. The personal accounts that we are using—and pick any one of these plans that are out there, 2 percent, 4 percent—Senator Baucus has made the claim that that does not, in and of itself, solve any of the long-term solvency problems.

Do you agree with that, that having money diverted into these accounts and having that invested at a certain rate would not have a positive impact? Obviously, when you divert money away, the guaranteed benefit would be reduced because you are only paying in 10.4 percent, for example, instead of 12.4 percent. Would that have a positive or negative impact on the long-term funding, given your predictions?

Mr. GOSS. Well, given our projections, clearly having money out of the trust funds go to individual accounts, from the narrow point of view of the trust funds themselves, does put stress on the trust funds and it does make it more difficult to then keep the trust funds in good shape.

However, if, as a result of having money out of the trust funds go to individual accounts, there is then taken to be, by our legislators, less of a need to have benefits actually come out of the trust funds because there is the belief that there will be more benefits then shifted to coming from the individual accounts than from the trust funds, then the trust funds can compensate for the money coming out by, in fact, lowering the benefit levels. That is essentially what the Commission Model 2 does.

Senator SANTORUM. And so as a result of these personal accounts, there is an improvement in solvency over time just by the fact of these personal accounts. Is that not correct?

Dr. HOLTZ-EAKIN. In our analysis of Commission Plan 2, let us define the terms. The problem is that the benefit line is above the revenue line for a long, long time.

Senator SANTORUM. Right.

Dr. HOLTZ-EAKIN. If we look at the impact of the different provisions of Commission Plan 2 on that gap in the near term, individual accounts in isolation make that gap wider; past 2065 or so they make that gap smaller, and the magnitudes are in the report.

Senator SANTORUM. The net effect over the super long term is?

Dr. HOLTZ-EAKIN. I would have to do the calculations.

Senator SANTORUM. You would have to do the calculations. All right.

Is there a difference between debt held by the public and debt held by Social Security from the standpoint of—well, there are a lot of different standpoints. But what is the difference?

We talk about, at some point, whether it is now with pre-funding through personal accounts or whether it is 13 years from now and shifting from Social Security debt to public debt, what is the impact on the economy, what is the impact on us? What is the general impact of having a transference from one debt to the other?

Dr. HOLTZ-EAKIN. Both are firm liabilities of the Federal Government and will be honored. Both will be honored through the three mechanisms in the Federal budget: taxes, lower spending, or rolling it over and borrowing again. So, the important economics will derive from what the public broadly thinks of that debt.

If they are looking into the Social Security system and seeing that debt, looking past it to see benefits in excess of taxes, and evaluating a shortfall as something they need to save and compensate for, then it has that impact.

If they look at the debt in the hands of the public and they realize the government is borrowing and I have to save, then they would be equivalent. One of the real tough issues is, do people recognize and consolidate the government's financial position when they make their individual decisions? So, it is hard to say with great economic certainty. The legal part is very simple.

Senator SANTORUM. Just a follow-up. You say "people." What about markets?

Dr. HOLTZ-EAKIN. Or markets, in the end.

Senator SANTORUM. Yes, I understand.

Dr. HOLTZ-EAKIN. So that is the same assessment, in my view.

Senator SANTORUM. So you have no idea how the markets would react to this shift? That really was the question.

Dr. HOLTZ-EAKIN. The markets will react to their overall assessment of the creditworthiness of the borrower. An important question is, what do markets believe about the future of the current Social Security program and the fiscal situation as a whole? If markets believe that this Congress and the administration will fix it, they will not react at all to a fix.

If they believe that there is an enormous trajectory where there is a big gap between them, they will react to a fix. So, current expectations are the anchor off which any reaction will come, and that is not written down anywhere.

Senator SANTORUM. Senator Wyden?

Senator WYDEN. Mr. Chairman, I would like to go after Senator Rockefeller, because he has not had his first round yet.

Senator SANTORUM. Oh, I am sorry.

Senator WYDEN. But I did want to ask another, and I appreciate that.

Senator SANTORUM. Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator SANTORUM. I do not know how I missed you.

Senator ROCKEFELLER. My approach to this is kind of "do no harm." As you both discussed—I listened to some of what you were talking about when I was gone—we have a lot of debts and a lot of things we have to worry about: Medicaid, Medicare, the borrowing from Chinese and Japanese banks which is overwhelming, and then the debt service from that, et cetera.

So "do no harm" is where I begin. Do no harm. You have indicated that it is better if we start right away, but you have also indicated if we wait a little bit it is not bad. It is not bad. It can be done. We are talking about the year 2075 or 2042, however you want to look at it.

Now, I will ask this to you, Dr. Holtz-Eakin, if you do not mind. You had your report, "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security." If this question has been asked, my colleagues can tell me.

That report got a lot of attention, in part, because it predicted that the average worker would do worse under the proposed reforms than under current law. I want to examine that and see if that is correct or not.

According to the CBO analysis, promised benefits under current law should be $23,300 for the median wage earner born in the 1990s. Is that more or less correct?

Dr. HOLTZ-EAKIN. Yes.

Senator ROCKEFELLER. All right.

And then CBO, when they do predictions of the Social Security shortfall, what level of benefits could the current system provide if Congress, in fact, did nothing?

That would be a period of years out.

Dr. HOLTZ-EAKIN. It looks like $19,100.

Senator ROCKEFELLER. Yes. Well, $18,100 is what I have. But in any event, that is down a little bit.

In your analysis of Plan 2 by the President's Commission, what could a future retiree expect in both proposed benefits and individual account income?

Dr. HOLTZ-EAKIN. The valuation we have for the sum of the traditional benefit, plus their current valuation of the future individual account, is $14,500.

Senator ROCKEFELLER. That is the number I have, also. Very interesting, it seems to me.

So if we continue where we are, we are in good shape. If we do not do anything, we are in less good shape, but we are still in better shape than if we enact what the Commission propounded.

Now, we do not know what the President is going to suggest tonight, but I think that ought to be something that we bear in mind.

Second, is it not correct that if we were to take, if this is to be suggested, the making permanent of tax cuts—we have already been through two huge rounds of tax cuts—if we make them permanent, if we just took one-third of that amount of the proposed—not the tax cuts up to this point, but just the making permanent of stretched out over the years in the same way they would stretch out the 75-year Social Security situation—would that one-third diminution, leaving two-third for permanent tax cuts, not solve the entire 75-year Social Security problem?

Mr. GOSS. By our projections, Doug suggests, and others have suggested, that the tax cuts are worth about 2 percent of GDP. As I mentioned earlier, our 75-year shortfall, in total, is equivalent to about 0.7 percent of GDP, so one-third sounds about right in aggregate for the period.

Senator ROCKEFELLER. Yes. I was going to use the figures, taking one-third, that the shortfall for the 75 years, which is a very long time——

Mr. GOSS. Which is 0.7 percent of GDP, on average.

Senator ROCKEFELLER [continuing]. Is about $3.7 trillion, and that the tax cuts, if made permanent, would be $11.6 trillion. So if you say, what percentage of that is 3.7, it is about one-third of the making tax cuts permanent. Now, that affects, particularly, people like myself who do not need it and should not be getting it, which is why I have voted against it.

It does not affect most of my people in West Virginia. It does affect other people, perhaps, and I respect that. But it is an interesting kind of a construct, that simply by declining to do something in full measure, even if it is done in two-thirds measure, we eliminate the entire 75-year problem and Social Security is free and clear forever.

Mr. GOSS. The one problem with that statement, sir, is the "forever."

Senator ROCKEFELLER. Forever. Strike.

Mr. GOSS. But it would solve the 75-year problem.

Senator ROCKEFELLER. Strike "forever." For 75 years.

Mr. GOSS. Our sustainable solvency would not be met by such a measure.

Senator ROCKEFELLER. Yes. Yes. My time is up, but I just started to ask one question. This is so short.

I am really interested in Roger Lowenstein's piece, which is really good, in the *New York Times.* He talks about the birth rates going down. He talks about immigration and that, in fact, Hispanics—and Krugman, in another thing, talks about the fact—do better than both Afro-Americans and whites.

The President went recently to a meeting of African-Americans and said, you are really going to get hurt by this because you die much younger and you do not work as long, therefore you do not get as much.

What, of course, he did not say, is that young blacks get killed disproportionately and tragically—and hopefully solvably—at a much earlier age, therefore, they do not tend to be in it.

But, in fact, when they do work and retire at the age of 65, their income from Social Security works out that it is only about 1 percent less than it is for the same white workers. So, it is very complex.

But the thought I just wanted to leave is the fact that we can solve the entire problem by restraining ourselves somewhat on our third major tax cuts for at least a lot of people who do not need it. I thank you, and I thank the Chair.

Senator SNOWE. The Senator from Oregon.

Senator WYDEN. Thank you very much, Madam Chair.

Gentlemen, this has been very helpful. My reason for staying is, a couple of hours ago I asked you about the comparison between the current situation in 1983 and I was interested in the features that you outlined that were different. Dr. Holtz-Eakin is absolutely right about health care costs, and you mentioned the immediacy, and there are other factors as well.

But one of the other reasons I emphasized 1983 is, there was some bipartisanship there. There was an effort to get beyond some of the polarization we are seeing right now and actually try to find some common ground and bring people together.

One of the other ideas that I have seen colleagues, Senators of both political parties, talk about, is what I want to explore with you briefly. That is the idea of saying, on top of Social Security—not to replace Social Security, but on top of Social Security—there would be an opportunity for what I think my colleague Senator

Snowe has characterized as an add-on, the idea that you would have supplemental savings. Of course, it would not be paid for by the Social Security payroll tax. That point needs to be emphasized.

Now, if such a thing were to be examined, it would seem to me you could have a scenario that would go something like this. You have this add-on or something with a similar kind of name that generates additional private saving—not coming from the payroll tax, but additional, new private saving—which helps to promote economic growth and jobs and productivity, which ought to help Social Security. Anything wrong with that analysis? Maybe, Dr. Holtz-Eakin, it is probably more appropriate for you. But is there anything wrong with that analysis?

Dr. HOLTZ-EAKIN. The big question is, will it be new private saving? Would an individual who adds on to Social Security cut back elsewhere in their saving behavior, is the big wild card.

Senator WYDEN. I think what I would be interested in is more information. I gather you all have not done any work on something like this yet, have you?

Dr. HOLTZ-EAKIN. We have not looked specifically at an add-on individual account.

Senator WYDEN. One of the ideas that I am going to ask constituents about is a new report that indicates something like $300 billion worth of tax money is owed and has not been collected.

Now, if you could figure out how to bring in some of that revenue—and that is, again, a big if—you could have a source of funds which might be available for some of the incentives for this add-on.

You could perhaps say to young people, if you are willing to save in addition to what is being secured by Social Security, perhaps the Federal Government would match it.

So, I want to make it clear that we are going to be looking at ideas like this, because I think something like this, when Senator Snowe called it an add-on apart from the Social Security payroll tax, it strikes me as being something that could be part of a long-term solution.

If it did, as you, Dr. Holtz-Eakin, correctly said, generate new private saving, not saving that supplanted something else, that is a path to growth. Would you care to comment any further on that, Dr. Holtz-Eakin?

Dr. HOLTZ-EAKIN. I am sorry. I was just contemplating the nightmarish thought of deciding——

Senator WYDEN. How to figure it out?

Dr. HOLTZ-EAKIN. Well, if we got the money from tax cheats, do tax cheats save? I do not know.

Senator WYDEN. I am not going to go there.

Dr. HOLTZ-EAKIN. Well, do not send me there.

Senator WYDEN. All right. [Laughter.] Mr. Goss?

Mr. GOSS. Yes, sir. Might I add that a proposal put together some years ago by Senators Moynihan and Bob Kerrey did, indeed, incorporate an add-on. In addition, the Commission, we will remember, had actually three different proposals, the first of which had in one of its variations the concept of being an add-on proposal. So, this is not a brand-new idea. It is one that has been considered.

Senator WYDEN. Are you talking about the Kerrey Kids Save proposal?

Mr. GOSS. No, more than that. Senators Moynihan and Bob Kerrey came up with a plan where they would have some changes in the benefit structure, but then they offered an opportunity, in addition, for employees to put up 1 percent that would be matched by 1 percent by their employers.

Senator WYDEN. My point is, what I think made that a non-starter was the point you just made, there was a change in the benefit structure.

So the question would be—and Dr. Holtz-Eakin and I are joking about the question of where you get the revenue source—is there a possibility for coming up with a true add-on so that you are going to close out this debate with respect to diverting payroll taxes and have a new kind of discussion that can trigger the savings revolution that this country so desperately needs and you have heard all kinds of Senators talking about?

Mr. GOSS. If I could, just from perhaps more of an actuarial than an economic point of view, what would be required to accomplish what you are talking about is that we have the add-on and that that be funded as a result of people consuming less, at least in the near term. In order for it to be true savings, people have to consume less and save more.

Senator WYDEN. Dr. Holtz-Eakin thinks you are being too logical, so I will break it off there.

Dr. HOLTZ-EAKIN. No, no. I doubt that. [Laughter.]

Senator WYDEN. Madam Chair, thanks.

Senator SNOWE. Thank you.

Senator Lincoln?

Senator LINCOLN. Thank you.

Just to kind of add to what Senator Wyden had mentioned on the savings, the Kerrey plan—which I did take a look at what was presented by Bob Kerrey and Moynihan—you said we would have to come up with a revenue source. We would have to come up with a revenue source for tax cuts too, and it was, technically, debt.

But if, in fact, we were to encourage more savings, what would that do to the economy in general, to provide more in terms of personal savings in this country? If we have looked at tax cuts as a way to grow the economy, how would the savings affect our ability to grow the economy in terms of the economics?

Dr. HOLTZ-EAKIN. Savings is the core of long-term economic growth. Economies grow by acquiring new technologies, by having more workers with greater skills, and by having the finances to equip them.

Senator LINCOLN. So, just as tax cuts can help us grow the economy, so can increasing the savings rate, making an investment in order to do that.

Two things that I would just like to have your input on. That is, we have noted that the current law ties the initial benefit to wages, and benefit, actually, to a lot of inflation.

I guess what we are really looking at is, in today's dollars, an average wage earner who began working in 1962 and retired in 2005 will receive nearly $400 less a month in benefits due to some of that, according to this Model 2. The reduction would happen whether you chose to participate, as you answered Senator Baucus, in the private accounts or not.

So I guess my concern here is, would that not produce a dramatic reduction for more people in terms of benefit, and thus put more people into poverty?

Mr. GOSS. If I might, the one thing that is important to keep in mind in this process is that it is a matter of what we are comparing it to. In truth, relative to the scheduled benefit out in 2075, we have projected that there would be about a 46 percent reduction.

But as we see now, by that same year, under current law, what we would be able to pay is 68 percent of those benefits, with no other changes. So, it is not exactly a 46 percent reduction from what would be payable, but a somewhat smaller reduction.

Senator LINCOLN. How much smaller?

Mr. GOSS. Well, it would be 46 percent rather than a 32 percent reduction under current law.

Senator LINCOLN. But for those that are living at the poverty line and are solely dependent on Social Security, a 32 percent cut——

Mr. GOSS. Versus 46 percent would be a difference.

Senator LINCOLN. It would be a difference, but it would still be devastating, is my point. If you are at the poverty line already and you are getting a 32 percent cut, that would be devastating.

Mr. GOSS. I think it is useful to step back and remember that these are the outer boundaries of two alternative visions of what you want the benefit to do.

Senator LINCOLN. Sure.

Dr. HOLTZ-EAKIN. I mean, wage indexing makes sure that the standard of living provided by Social Security in retirement is roughly comparable to one's standard of living while working. There is some ratio there, a replacement rate.

Price indexing, in the extreme form, sets a floor for the standard of living in retirement that is not necessarily going to go up if you had a better standard of living during your working years.

So, it is a question of, what do you want the system to provide, a floor or something that moves up relative to how you have done in your working years?

Senator LINCOLN. Well, I guess the two issues I really want to reflect on in regard to that are, one, in 2002, which I guess is the last year that there are numbers, $4.7 billion flowed into Arkansas' economy through Social Security benefits.

Again, I mentioned that there are 7 of the 10 States represented here that have the largest number, as a proportion of their population, of seniors. There is a tremendous input into the economy.

The expected cuts under that Model 2—and we know that it is a model, but it still has been, certainly, visibly out there—were to take effect, you are going to have a real concern for States' economies, particularly many of us that have rural natures, disproportionately high numbers of seniors.

Has there been any studies in terms of what it does to States' proportionately from that perspective in terms of the loss of revenues that are going to be going into those States because of the cuts in benefits?

Dr. HOLTZ-EAKIN. I have not seen these State by State. I think it would be important to note that the timing is over a very long horizon. This is not happening right away. The economic responses of all working people, Arkansas and elsewhere, will determine the economic impacts on the State and what people do with their working careers.

Mr. GOSS. I would suggest that looking just at the defined benefits in Social Security is, in fact, not the whole picture in terms of income, but they will be coming to the State if matched with that. Under Commission Model 2 with the individual accounts, there would be revenue coming from annuities based on other revenues coming to individuals based on their individual accounts. Looked at in their entirety, I think if you want to look at the effects on the States, you would have to look at the entirety of the two provisions.

Senator LINCOLN. Except for the fact that when you have got a State like ours, where 50 percent of the people have an adjusted gross income of less than $25,000, and 80 percent have an adjusted gross income of less than $50,000, in terms of the low income, when you talk about additional accounts, particularly private accounts, which presumably these that are going to be more readily accessing Social Security sooner than later, are not going to have time to accrue those revenues in those accounts.

The last point that I would just like to make sure that you have the opportunity to comment on is the fact that, for us in Arkansas, disproportionately, women are dependent on Social Security. Fifty-eight percent of all people over the age of 65 in Arkansas who rely on Social Security benefits are women.

We are a little bit above, I think, the national average. But, nonetheless, women do tend to live longer and they spend down their resources as a caregiver, and they ultimately find themselves solely dependent on Social Security.

So I guess, in terms of looking at at least the next 20 years or 30 years, you are going to see a disproportionate burden put on women and elderly women if, in fact, you see the reduction in benefits, as well as those who are in the lower income brackets that do not have the dollars to put into private accounts over time to accrue. Do you agree with me?

Dr. HOLTZ-EAKIN. We have not looked at the gender breakdown of any particular plan, but we certainly can look at it.

Senator LINCOLN. I think that would be important. It is important to recognize that, again. Whatever demographics, whether women live longer or what have you, the fact is, they will be disproportionately hit by some of the proposals that are being talked about, and I think that is a critical thing that we have to look at.

Mr. GOSS. That is correct.

One critical point on the kinds of proposals you are looking at, though, really is, when an individual account accrues up to the point of return, what is done with it then? If at that point both men and women can purchase life annuities on an equal basis, then women would not be disadvantaged relative to men if they have the same amount in an account. If they do not buy an annuity on an equal footing basis, however, they simply utilize the money, and women live longer, they will be living longer with the same amount of money accumulated in the account.

Senator LINCOLN. But you are really talking about today's kindergartners. You are not talking about the women between the ages of 30 and 65 right now because they are not going to have that opportunity under this proposal.

Mr. GOSS. It is a gradual phase-in. Certain of today's kindergartners will be the generation that will, through their whole entire career, be faced with the individual account plus the reduced benefit. But people who are under 55 will have a portion of those changes that will phase in gradually.

Senator LINCOLN. Would you not also agree that those kindergartners today are going to have to spend the next 20 years or better accruing enough money in that personal account to even warrant the investment in the financial world and the financial market? I mean, most financial groups do not want to hassle with an account that is only $50, $100, even $1,000. So when we talk about private accounts, we have got to have a receptive marketplace. Or do we let those accounts accrue until those people are 20 and then they have got enough to invest that the financial markets actually want to see them?

Mr. GOSS. These are difficult questions. Most of the plans that we have dealt with in talking with members of Congress and others have envisioned not going to the individual brokers to set up your accounts with Vanguard and Fidelity, but rather to have something like the Government Employee Thrift Savings plan, a central structure through which you could more easily support small accounts.

Senator LINCOLN. I would just like to add that I think some of the savings that Senator Santorum was mentioning, though, when you talk about the savings or the plus side of those, we do not really realize that until the latter part of the century, right?

Mr. GOSS. When you say "the savings," do you mean——

Senator LINCOLN. Well, he was mentioning the idea, the possibility of some of these, not necessarily private accounts, but the investment and what the private accounts allow Social Security to do in terms of the insolvency. That does not happen for almost 40 or 50 years, right?

Mr. GOSS. It happens to a small degree starting perhaps as much as 10 years into the future. If accounts were to start today, for instance, for people age 55, then when they retired at age 62, they would have an account to help augment their Social Security retirement benefits.

So within 10 years you would start to have some, but they would have only 7 years' worth of contributions. They would not have the full 40-year career to make contributions.

Senator LINCOLN. Right. And it certainly would not make up the difference in terms of the debt incurred through the losses with the deduction that would be made out of the payroll tax.

Mr. GOSS. It might. Really, it depends on how a proposal is structured.

Senator LINCOLN. Your studies indicate that it will not, but CBO's did.

Mr. GOSS. In our studies, there was some attempt on a Commission level to try to structure the reduction in the Social Security benefit to be somewhat in synch or to match up to a degree with the accruing amounts that would be expected to occur in individual accounts.

Senator LINCOLN. Well, I have used more than my time, but you gentlemen have been generous, and we appreciate it. We look forward to more discussions.

Thank you, Madam Chairman.

Senator SNOWE. Thank you.

I have just a couple of more questions. You have been more than patient.

Mr. Goss, in looking at the trustees' report again, we were talking earlier about the intermediate, low-cost, and high-cost assumptions. How often have the trustees adopted the intermediate versus the low-cost? The difference between intermediate and low-cost is a dramatic difference in 2045, where with the low-cost, obviously, there is a continuous surplus through 2080.

So have these variables been included in those assumptions? They obviously vary greatly. Is it all of them combined that makes the difference between the two sets of assumptions?

Mr. GOSS. It is all of them combined. When we go to the high-cost and the low-cost, we have really taken the principal economic and demographic assumptions and we have varied them for the high-cost, all sort of in a generally negative direction, and the low-cost in a positive direction.

It results in a scenario that is rather unlikely, probably no more than a 1 or 2 percent probability, maybe 5 percent probability that things would be as good or as bad as these extremes. They are really intended just to indicate a probablistic range of where we might fall.

Senator SNOWE. I see. And what would have the greatest impact in the assumptions that are used? Is it the birth rate, the economic growth, the death rate, or immigration?

Mr. GOSS. Well, Senator, if we all followed the model of Senator Santorum, we clearly would have no problem for the future of Social Security. The fertility rate really is a very, very strong lead variable here. We are now at about a 2 fertility rate. Had that fertility rate stayed at the level of about 3, we would not be talking on this topic today.

Senator SNOWE. And so, then, consistently more right than wrong in using the intermediate set of assumptions over the last 20 years?

Mr. GOSS. Well, unfortunately, you would be consistently wrong in using any particular projection at any point in time, because reality, unfortunately, is never kind enough to match our projections. But the real measure, I think, would be, would you be too high about half the time and too low about half the time? We think that that is about where you would fall out.

Senator SNOWE. All right.

Finally, Dr. Holtz-Eakin, about the idea of improving the rate of return for the Social Security trust fund and investing in government beyond the Treasury securities, investing in government agency securities. I gather there is no prohibition against that notion. Has it ever been considered, and is that a possibility? Would that improve the rate of return?

Dr. HOLTZ-EAKIN. Whether it has been considered to invest the trust fund?

Mr. GOSS. It has been considered. In fact, it has even happened, I believe most recently, with the disability insurance trust funds. I forget which of the three mortgage-backed securities it is that, in fact, meets the obligation of the full faith and credit of the government, but that is what is really required, is that the obligations in the trust fund have to enjoy the full faith and credit, and one of the three mortgage-backed—is it Fannie Mae? I am not really sure—does, indeed, meet that. The trust funds have held those securities.

Senator SNOWE. So why have they not done more of that? Why have they not invested more in government agency securities to improve the rate of return?

Dr. HOLTZ-EAKIN. From a budgetary point of view, it is backed by the full faith and credit, the taxing power of the Federal Government, and it is a wash in the end.

Senator SNOWE. So you would not score it any differently.

Dr. HOLTZ-EAKIN. No.

Senator SNOWE. Is there any way of improving the rate of return other than, obviously, the direct investment in the stock market? Is there a possibility in considering that in some way, some index funds? Some of it? Not all of it? A portion of it? Maybe the $150 billion surplus that occurs each year. Is that a possibility? Would that change it?

Dr. HOLTZ-EAKIN. The transactions between the Social Security program and the remainder of the budget net zero for the government as a whole.

Senator SNOWE. But actually taking money aside.

Dr. HOLTZ-EAKIN. Actually saving?

Senator SNOWE. Right.

Dr. HOLTZ-EAKIN. Well, if there was a mechanism by which the Federal Government could save, it would have the same economic implications of individuals saving more, the Nation saving more. All would provide enhanced growth in the Nation. The risks would be the same and the risk adjusted rates of return, the outcomes, would be the same. The question is, what mechanism would most effectively raise national saving?

Senator SNOWE. Improving the rate of return. I mean, is that not achieving the same goal in some other way? I mean, inherently what is wrong with investing in private securities?

Dr. HOLTZ-EAKIN. There is nothing wrong. The core problem, as I mentioned at the outset, is the fact that the benefits are above the taxes dedicated to the program. That gap will be filled somehow from the remainder of the Federal budget, and that is independent of the kinds of things which are rates of return on particular investments.

Senator SNOWE. And the same would be true in diverting the payroll tax and the creation of private or personal savings accounts.

Dr. HOLTZ-EAKIN. As I said at the outset, I think the rate of return issue should be done in about three steps. Step one, is do you want to have a pay-as-you-go Social Security system that goes on for a long, long time?

If so, the rate of return that you can offer individuals is the rate of growth in payrolls, because as payrolls grow, you apply the tax rate, there are more benefits.

That will be something, it looks like, between 1.5 to 2 percent if we had a sustainable, pay-as-you-go system. We do not. So the rates of return in a pay-as-you-go system could be less, could be lower because we would have to raise taxes or cut benefits.

If you went to a pre-funded system, whether that is funded by the government investments or funded by individual investments, you have the opportunity to get higher rates of return, even if you just put it into Treasuries, which have averaged 3.3 percent inflation-adjusted, over time.

You just have to figure out how to get there, how you are going to pay for it. And if you want to take more risk, government or individual, you could perhaps get higher rates of return in corporate bonds or corporate equities. Those are the different rates of returns that are on the table.

The riskiness does not differ depending on who does the investment, government or individual, and rates of return depend on the structure of the program. So, those are the courses. What kind of program? Pay-as-you-go, the rate of return is dictated by payrolls. Pre-funding, to some extent, the rate of return is dictated by the riskiness of the investment.

Mr. GOSS. And if I might add, in the last administration there were proposals, as you are aware, to in fact have some of the trust funds invested in other than government bonds. We made estimates along those lines.

The controversy, if there is any here, is really exactly on the point that you make about our rates of return, whether or not there should be thought to be a higher expected rate of return by investing in riskier, or I would say more volatile or more fluctuating, assets. There is some controversy over exactly how to actually portray the higher expected rate of return that is associated with the ones that have higher fluctuation.

Dr. HOLTZ-EAKIN. Well, at the risk of turning this into a finance seminar, I do not think there is any great controversy. I think it is widely established that the expected return on corporate equities will exceed that on Treasuries. The issue is, at present, how does an individual value that higher expected return in the face of the fact that it comes with more risk?

The market experience is that individuals value that expected return highly, and the risk highly as well. The net effect of a positive return and negative for risk is that they made it with safer investments like Treasuries and they will take a hair cut in order to avoid the risk. The rates of return are what they are. They will think of them when they make the decision about where to put their money.

Senator SNOWE. In terms of thinking about the Social Security program in and of itself, I understand the distinctions that you are making. I think the question is whether or not you can generate a better rate of return, investing in some way in private securities with obviously the safeguards that would be essential to doing that. I think it is good for individuals, we are hearing today, and it ought to be good for government, somewhat. I think that is the issue.

Mr. GOSS. At the risk of perhaps making some controversy, I would suggest that most private pension plans and individuals, when they look at their portfolios, understanding the higher volatility associated with the stocks, but also the higher expected return, they make decisions about how to spread their portfolio across these different instruments.

One could make an argument that the Social Security's investments—in effect, to the extent it has advance funding in investments—are entirely in government bonds, so it is conceivable that one could argue that having some investment in the higher yield and the more volatile instruments could be a benefit.

Senator SNOWE. I want to thank you both very much. I know, speaking on behalf of all of the members here, we thank you for your contribution. I would expect that we will be calling you back again and again.

This hearing is adjourned.

[Whereupon, at 12:55 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

CHART SUBMITTED BY SENATOR BAUCUS

Current Law, Trust-Fund Financed

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	226%	89%	67%
1950-59	170%	82%	63%
1960-69	160%	81%	62%
1970-79	177%	85%	64%
1980-89	205%	91%	64%
1990-99	219%	95%	67%
2000-09	225%	97%	68%

Plan 2, Trust-Fund Financed

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	227%	90%	67%
1950-59	174%	82%	61%
1960-69	162%	80%	57%
1970-79	176%	82%	57%
1980-89	200%	85%	55%
1990-99	197%	80%	53%
2000-09	179%	73%	48%

Current Law, Scheduled Benefits

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	226%	89%	68%
1950-59	171%	81%	63%
1960-69	158%	79%	61%
1970-79	171%	81%	61%
1980-89	196%	84%	59%
1990-99	199%	84%	57%
2000-09	194%	79%	54%

Current Law, Dedicated-Tax Financed Benefits

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	226%	89%	68%
1950-59	171%	81%	63%
1960-69	158%	79%	61%
1970-79	171%	81%	61%
1980-89	196%	84%	59%
1990-99	199%	84%	57%
2000-09	194%	79%	54%

Plan 2, Scheduled Benefits

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	227%	90%	67%
1950-59	174%	82%	61%
1960-69	162%	80%	57%
1970-79	176%	82%	57%
1980-89	200%	85%	55%
1990-99	197%	80%	53%
2000-09	179%	73%	48%

Plan 2, Dedicated-Tax Financed Benefits

10-year Birth Cohort	Average Ratio in Lowest Household Earnings Quintile	Average Ratio in Middle Household Earnings Quintile	Average Ratio in Highest Household Earnings Quintile
1940-49	224%	88%	66%
1950-59	168%	78%	58%
1960-69	150%	73%	52%
1970-79	163%	75%	53%
1980-89	187%	80%	52%
1990-99	183%	77%	51%
2000-09	171%	71%	47%

PREPARED STATEMENT OF HON. JIM BUNNING

I'm glad we are having this hearing today and starting the Social Security debate.

Social Security has been a successful program that is serving millions of Americans well in their old age or during a disability. Many Americans rely on their Social Security checks for a large part of their monthly income.

However, much has changed since the program was created in the 1930s. For example, people are living longer. In 1935, the average life expectancy was 63 years. Today, it's 77 years.

We also have fewer workers paying for the benefits of current retirees. In 1950, there were 16 workers for each beneficiary. This year, it is 3.3 workers for each beneficiary. In about 25 years, that number will drop to 2 workers for each beneficiary.

Unfortunately, the program is facing a fairly bleak financial future. According to the 2004 Social Security trustees report, in only 13 years, Social Security will begin paying out more in benefits than it collects in revenue.

By the year 2042, the Social Security trust funds will be depleted, and the program will be insolvent. Beneficiaries will be facing about a 30-percent cut in benefits.

I realize the CBO has slightly different projections on Social Security's financial outlook, but that doesn't diminish our need to reform the system.

We owe it to our children and grandchildren to have an honest debate on this issue and put this program on a financially sound path. No one wants to cut benefits or change the benefits for people currently on Social Security or those nearing retirement age. That wouldn't be fair.

But what we do want to do is make sure that our grandchildren and future generations have a viable retirement system. Personally, I think the best way to do that is through reforming Social Security to include voluntary personal investment accounts.

These accounts could allow workers to build a nest egg for their retirement and allow younger workers to enjoy the same retirement security that current retirees do today.

I look forward to hearing from our witnesses today about the future of Social Security. This is an extremely important topic, and I hope we can work together as a body to strengthen Social Security.

Thank you.

PREPARED STATEMENT OF STEPHEN GOSS

Mr. Chairman, ranking member, and members of the committee, thank you very much for the opportunity to talk with you today about the future financial status of the Social Security program.

Annual reports from the Board of Trustees to the Congress on the financial condition of the Old-Age, Survivors, and Disability Insurance program have been prepared continuously starting with 1941. These reports are required by law to include an assessment of the "actuarial status" of the Trust Funds. The Office of the Actuary at the Social Security Administration prepares the projections used in these reports as well as projections of the effects of proposals to change the program, and has done so since the inception of the program in 1935.

Today I would like to speak about three aspects of our analysis of the actuarial status of the Social Security program under current law. These are (1) the basic status of financing and solvency over the 75-year long-range period, (2) the principal reason that the financial status is shifting, and (3) some of the long-range measures used for assessing the financial/actuarial status of the program.

(1) WHERE WE ARE—THE BASIC ACTUARIAL STATUS OF THE SOCIAL SECURITY PROGRAM

In the 2004 Trustees Report, the intermediate projections indicate that the annual excess of tax income over program cost will begin to decline in 2009, and in 2018 cost will exceed tax income. At that point the accumulated trust fund assets of about $2.3 trillion in present value will begin to be used to augment tax income so that benefits scheduled in current law will continue to be paid in full.

If no changes are made, it is projected that the combined Trust Fund assets would become exhausted in 2042 and the program would no longer be considered to be solvent. This means that we would no longer be able to fully pay benefits scheduled in current law on a timely basis. Instead, we would be able to provide 73 percent of scheduled benefits with continuing tax revenues. After 2042, program cost is projected to continue growing faster than tax income. By 2078, 68 percent of scheduled benefits are expected to be payable.

(2) WHY IS THE FINANCIAL STATUS SHIFTING?

So why is the cost of the program projected to be rising faster than program income? The principal reason is that birth rates rose to a 20-year high level for the period 1946–1965, averaging over 3.3 children per woman, followed by a rapid decline to about 2 children per woman in 1972. Total birth rates have stayed at this relatively low level ever since, and the intermediate projections reflect the assumption that birth rates will continue at this lower level.

A shift in birth rates to lower levels has the direct but delayed effect of increasing the "aged dependency ratio," that is, the ratio of people over 65 to the working age population between 20 and 64. Graph 3 shows that the aged dependency ratio is projected to rise sharply between 2010 and 2030, as the large baby-boom generation moves above 65 and is replaced at the working ages by the relatively low birth-rate generations that follow them. The continued lower birth rates make the upward shift in this ratio permanent. The more subtle rising tendency in the ratio before 2010 and after 2030 is the result of steady increases in life expectancy.

Graph 4 shows the often cited ratio of workers per beneficiary, which follows almost directly from the trends in the population after the Social Security program matured around 1975. The declines in this ratio through about 1960 were largely due to the maturing of the retirement program. Most workers were covered starting in the 1940s, but retirement benefits were not available generally to the oldest population until many years later. Further declines in the ratio through about 1975 were largely the result of extending benefits to younger workers who had become disabled. Since 1975, this ratio has been stable at around 3.3 workers per beneficiary, reflecting the stability in the aged dependency ratio. However, the number of workers per beneficiary is projected to decline in concert with the rising aged dependency ratio, starting around 2010, reaching a new relatively stable level of about 2 workers per beneficiary by 2040.

Graph 5 shows the inverse, or flip of the ratio of workers per beneficiary. This is useful because it illustrates the direct relationship between this ratio of beneficiaries to workers and the aged dependency ratio just above it.

Finally, Graph 6 shows the projected cost rate for the Social Security program. This is the annual cost of the program as a percent of the payroll tax base. With the tax income to the program at about 13 percent of taxable payroll, it is evident that the intermediate cost projection moves above income around 2018 and is expected to remain higher. It is also evident from these graphs that the shift to a higher cost rate between 2010 and 2030 is again largely the result of the shift in birth rates.

While uncertainty is inherent in any estimate for the future, these trends are nearly unavoidable and are still evident even for the high-cost and low-cost projections included in the Trustees Report. Stochastic projections included in the last two reports indicate that actual future experience will fall within this range with about a 95 percent probability.

(3) LONG-RANGE MEASURES OF ACTUARIAL STATUS

As mentioned earlier, solvency of the Social Security program is assessed at each point in time. The program is solvent if there are assets in the Trust Funds sufficient to fully pay scheduled benefits on time. Under the law, the program does not have the authority to borrow when the Trust Funds have become exhausted. While benefit payments would continue after exhaustion of the Trust Funds, they would need to be paid at a reduced level.

Thus, the first real criterion for the actuarial status of Social Security is whether the program is expected to be solvent throughout the 75-year long-range period. The second criterion is whether the program meets the test of sustainable solvency. This test requires that the positive trust fund levels at the end of 75 years are stable or rising as a percent of the annual cost of the program. This condition is generally met if the tax income is stable at about the same level as program cost at the end of the long-range period. These have been the two basic goals that have guided legislative proposals developed over the past 10 years.

SUMMARY MEASURES

Several summary measures have been developed over the years that provide general indications of the adequacy of financing over a period as a whole. However, caution should be exercised in using these summary measures, because they provide no indication of the solvency of the program within the period.

The actuarial deficit of the Social Security program is essentially the shortfall of income needed to fully meet scheduled benefits over the entire period. The actuarial deficit is currently estimated at 1.89 percent of payroll for the 75-year projection period under the intermediate assumptions.

Closely related is the unfunded obligation of the Social Security program, which indicates that the projected shortfall for the next 75 years is about 0.7 percent of GDP for the period as a whole. The unfunded obligation may also be expressed as a total dollar amount in present discounted value. This estimate is $3.7 trillion for the shortfall that must be met over the next 75 years as a whole. Because 75 years is a very long time, estimates for the long-range period are subject to considerable uncertainty.

For the last 2 years the Trustees have also added measures of the unfunded obligation of the program over the infinite future. Due to the length of this time period, these measures are highly uncertain. They are intended only to provide an indication of the potential magnitude of shortfalls over the infinite future as a whole.

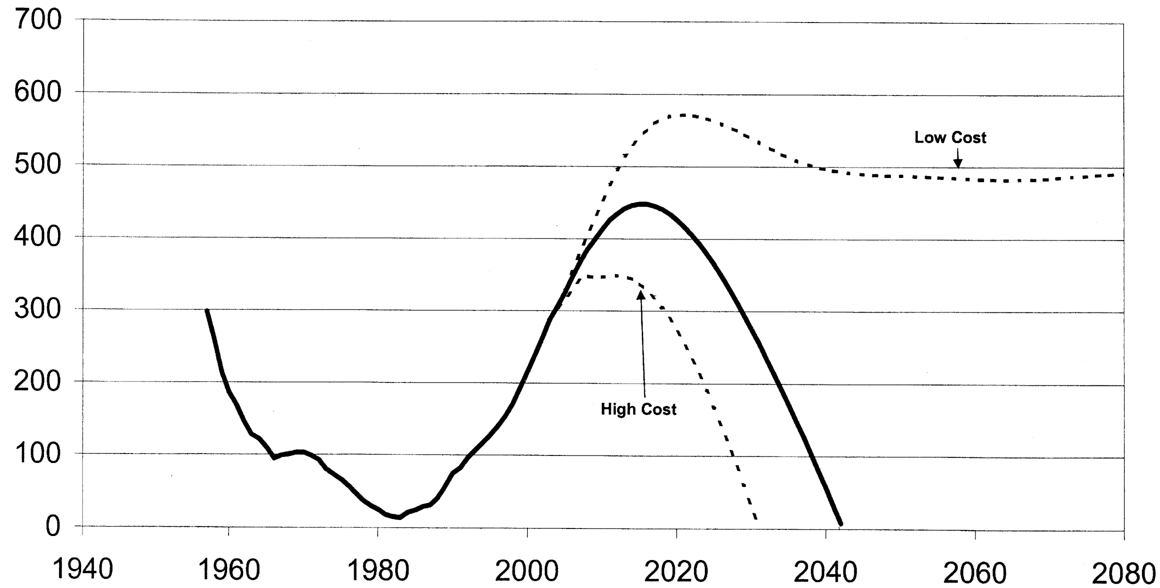
CONCLUSION

The test of sustainable solvency, if met, indicates that the Social Security program is expected to be able to pay scheduled benefits on a timely basis for the foreseeable future. It means that the program is on a financially sustainable path. Currently the Social Security program is in need of some combination of reductions in cost and increases in income to meet this objective. Because the upcoming shift in the cost of the program is closely related to a shift in birth rates, the shortfall can be met by changing the level of benefits or income with a gradual transition over several decades.

Clearly, acting well before we approach the expected date of trust fund exhaustion will be advantageous. By enacting needed changes sooner we will have more options to consider; we will be able to phase changes in more gradually and give affected individuals more advance notice.

Thank you very much for the opportunity to present these remarks.

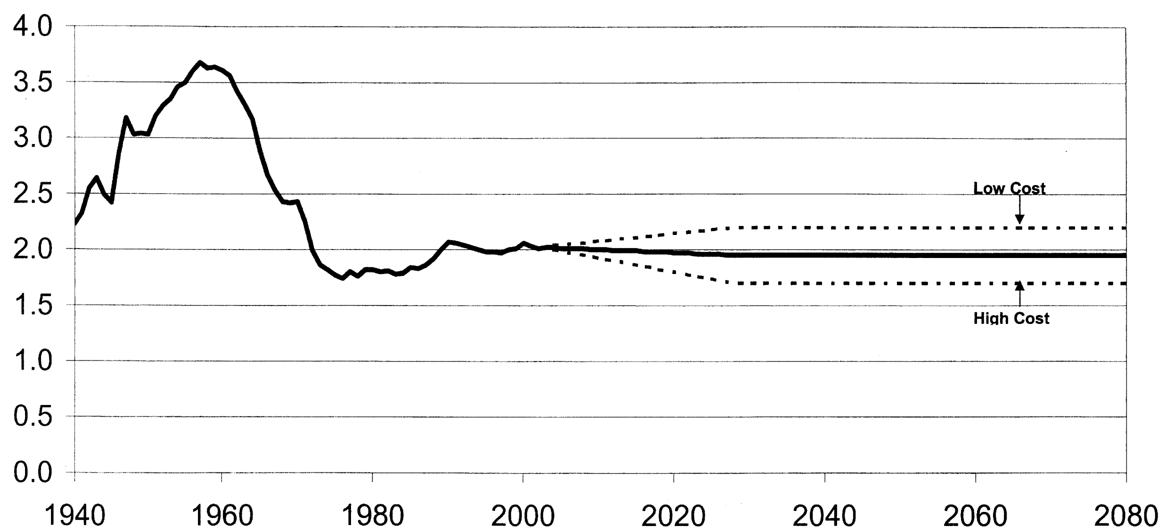
Graph 1--OASDI Trust Fund Ratio



Based on the 2004 Trustees Report

Social Security Administration
Office of the Chief Actuary
January 20, 2005

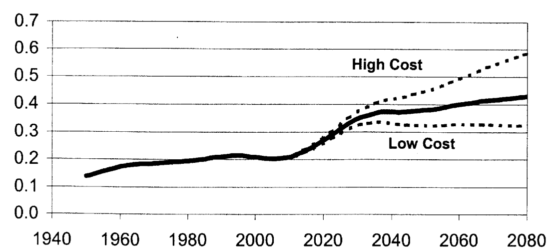
Graph 2--Total Fertility Rate



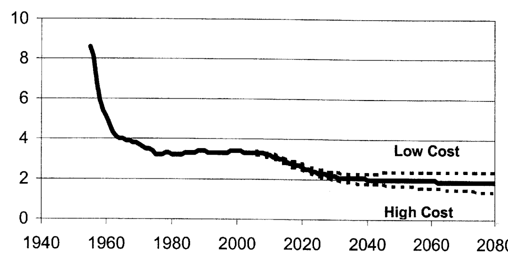
Based on the 2004 Trustees Report

Social Security Administration
Office of the Chief Actuary
January 20, 2005

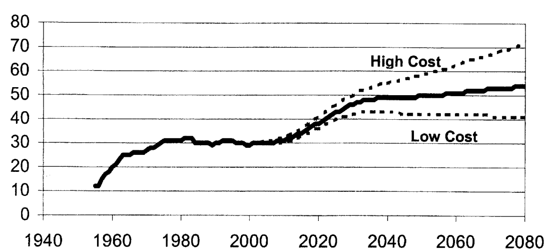
Graph 3--Aged Dependency Ratio



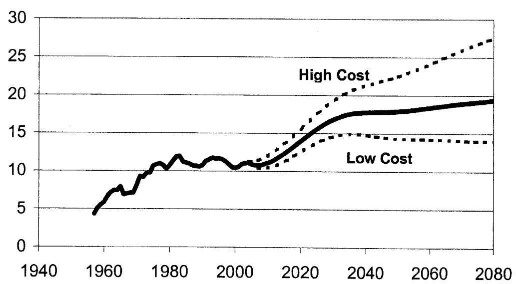
Graph 4--Covered Workers Per OASDI Beneficiary



Graph 5--Beneficiaries Per 100 Covered Workers

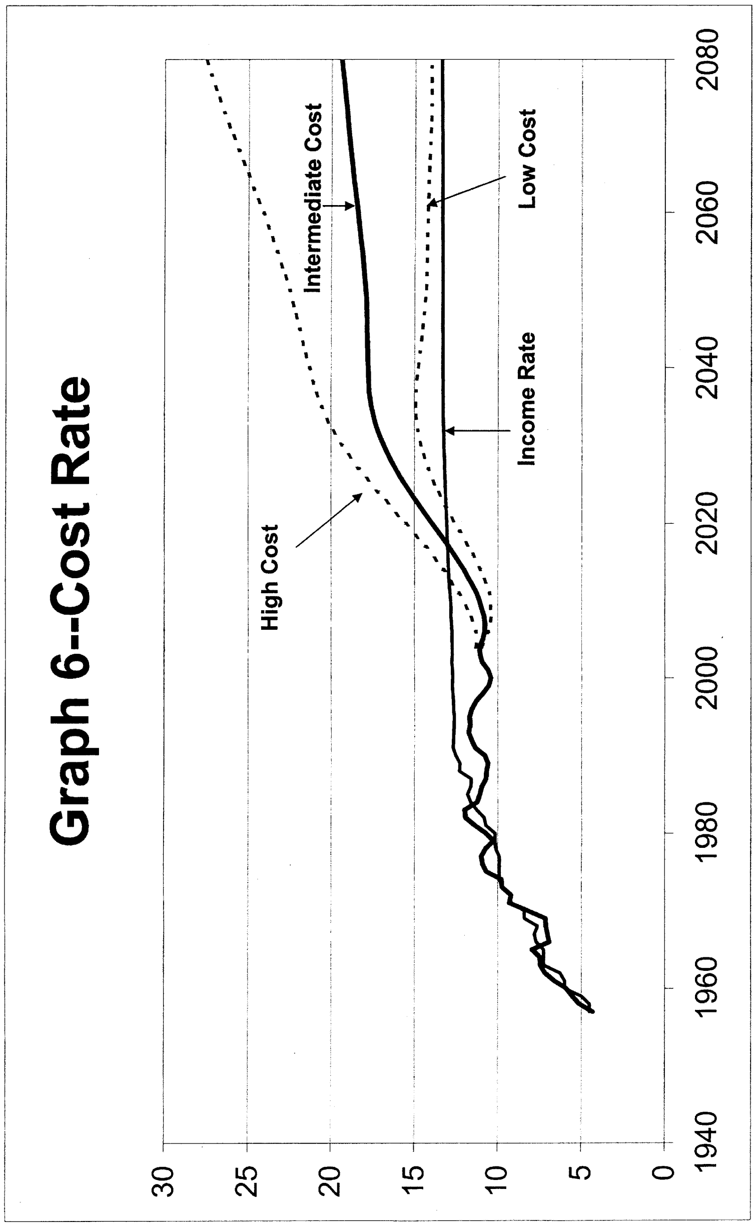


Graph 6--Cost Rate



Based on the 2004 Trustees Report

Social Security Administration
Office of the Chief Actuary
January 20, 2005



Graph 6--Cost Rate

Based on the 2004 Trustees Report

Social Security Administration
Office of the Chief Actuary
January 20, 2005

Social Security Actuarial/Financial Status

Solvency---Ability to Pay Scheduled Benefits with Available Revenue--At any point in time

1) Requires a positive Trust Fund level--- No borrowing authority under current law

2) If benefit cost exceeds current tax revenue, augment with Trust Fund assets (2018)
If Trust Fund assets exhausted, pay what current tax revenue allows (2042)

Sustainable Solvency-- Solvent for the foreseeable future

1) Requires a positive Trust Fund through the long-range 75-year period

2) Also requires that Trust Fund assets are stable or rising as a percent of annual cost at the end of the long-range period.

Summary measures of financial status of the Social Security program

1) Actuarial Balance--Excess of assets and income over cost--
Expressed as a percent of the payroll tax base, or taxable payroll
A negative actuarial balance is an "unfunded obligation"
Actuarial balance is -1.89 percent of taxable payroll for the 75-year period

2) Others measures of Social Security unfunded obligation
These are the net shortfall of income and assets to cover cost over the period

For the 75-year Long-Range Period 2004-78	
Actuarial deficit	1.89 percent of taxable payroll
Unfunded obligation	0.7 percent of GDP
Unfunded obligation	$3.7 trillion in present value

Total effect of changes needed for the next 75 years as a whole

For the Infinite Future: 2004 and later	*HIGHLY UNCERTAIN*
Actuarial deficit	3.5 percent of taxable payroll
Unfunded obligation	1.2 percent of GDP
Unfunded obligation	$10.4 trillion in present value

Total effect of changes needed for ALL future years as a whole

Estimates from the 2004 Trustees Report using Intermediate Assumptions
Prepared by Office of the Chief Actuary, Social Security Administration
January 20, 2005

RESPONSE TO A QUESTION FROM SENATOR GRASSLEY

Question: In your testimony, you describe some of the advantages, or benefits, of acting sooner rather than later to reform Social Security. If we turn your point around, how would you quantify the disadvantages or costs of continued delay?

Answer: In regard to restoring solvency, and sustainable solvency, for the Social Security program, most proposals have principally targeted changes in revenue and benefit levels to eliminate the shortfalls, or annual deficits, of the program for the years in which these deficits occur after the point where the trust funds would otherwise have become exhausted. As the time at which these deficits are projected to occur is still many years in the future, the size of changes needed to correct them is not expected to change significantly whether they are enacted into law this year or next year or the year after.

For example, based on the intermediate assumptions of the 2005 Trustees Report, eliminating the deficit for the year 2042, the first full year after trust fund exhaustion, solely with reductions in scheduled benefits would require a reduction of about 26 percent. Whether enacted now or next year, the magnitude of the reduction needed to accomplish this result is expected to be the same.

The disadvantage of delaying substantially the enactment of changes that will restore solvency and sustainable solvency for Social Security are three. First, with greater delay, any enacted changes will likely provide less advance notice to those workers and beneficiaries who will be affected. Second, if enactment is delayed very substantially, then the ability to phase in any changes gradually so as to avoid abrupt changes in benefit levels or revenue changes will be diminished. Third, if enactment is delayed substantially, then options will become progressively more limited. At the extreme, if enactment were delayed until 2041, options would be limited essentially to a virtually immediate reduction in benefit payments of around 26 percent for all beneficiaries, a virtually immediate increase in revenue equivalent to about 4.3 percent of payroll or about 1.5 percent of GDP, with larger changes thereafter. Delays in enactment of only 1 or a few years would have far less drastic consequences.

Responses to Questions From Senator Baucus

INCREASE IN DEBT

Question: Mr. Goss, today, Federal debt held by the public is about $4.3 trillion. Is it correct that your analysis of Model 2 of the President's Commission shows that debt held by the public would increase by $4.7 trillion in today's dollars by 2041?

Answer: On page 58 of our actuarial memorandum for the Commission proposals (see *http://www.ssa.gov/OACT/solvency/PresComm_20020131.pdf*) we indicated that the expected increase in publicly held debt would be about $2.3 trillion in constant 2001 dollars (indexed for expected CPI increases back to 2001) for Model 2 as a whole. This increase in publicly held debt was projected to diminish after 2041 and to become a reduction in publicly held debt for 2052 and later. These estimates reflect our assumption that participation in the individual account option would be about two-thirds of the potential. Expressed in constant 2005 dollars, the amounts in this table would be about 13 percent higher than those expressed in 2001 constant dollars.

Question: Mr. Goss, the $4.7 trillion increase in debt held by the public under Model 2 includes savings from switching from wage-indexing to price-indexing of initial benefits. If the private accounts and "clawback" in Model 2 were enacted, but the switch from wage-indexing to price-indexing were not enacted, how much would Federal debt held by the public increase by 2041? In 75 years?

Answer: Page 57 of the memorandum cited above indicated that we estimated a $2.6 trillion (constant 2001 dollars) decrease in publicly held debt by the end of 2041 as a result of implementing only the basic provisions of Commission Model 2. Thus, the incremental effect of providing for the individual accounts, and the General Fund transfers required to maintain trust fund solvency, would be to increase publicly held debt by about $4.9 trillion (constant 2001 dollars) by the end of 2041. It should be noted however, that along with this projected increase in publicly held debt, the plan in total would also result in a positive trust fund balance at the end of 2041 of about $0.3 trillion in present value and individual account and annuity assets at the end of 2041 of about $1.7 trillion in present value (see page 48 of the memorandum). Expressed in constant 2001 dollars, these asset levels would be about $1 trillion and $5.5 trillion, respectively.

By the end of 2075, publicly held debt was projected to be reduced by $18.9 trillion (constant 2001 dollars, see page 58) by Model 2 in total, and by $31.7 trillion (constant 2001 dollars, see page 57) for the basic provisions alone.

DAY OF DISASTER IS MOVED UP

Question: The President's Social Security Commission emphasized that Social Security's funding would be in dire straits by 2016. At that time, Social Security's annual outgo would exceed its annual income. Under the latest Trustees' report, that date would be 2018.

Isn't it true that Model 2 as recommended by the Commission would move that date up by 10 years, to 2008, not move it back?

Answer: Page 38 of the actuarial memorandum cited above indicated that we projected the year in which Social Security expenditures would first exceed tax income would be 2010 under the Commission Model 2, compared to 2016 under current law. Of course, unlike current law, positive cash flow was also projected to be restored, by 2059 under Model 2.

BENEFITS ARE CUT EVEN IF NO PRIVATE ACCOUNT

Question: It is my understanding that under Model 2 as recommended by the President's Commission, initial benefits would be calculated using price-indexing rather than wage-indexing. This switch would result in deep benefit cuts.

Isn't it true that the benefit cuts resulting from switching from wage-indexing to price-indexing would apply to all retirees, even those who had opted not to participate in the private accounts option?

Answer: That is correct. Under Commission Model 2, the modified "price-indexed" benefit formula would apply to all Social Security beneficiaries, whether they participated in the individual account option or not. The "low-earner enhancement" provision would also apply for all beneficiaries.

PRICE-INDEXING WILL CAUSE DEEP BENEFIT CUTS

Question: Model 2 of the President's Social Security Commission would switch the calculation of initial Social Security benefits from wage-indexing to price-indexing. This would result in deep cuts in initial benefits.

Mr. Goss, could you tell me your estimate of the size of the percentage cut for initial Social Security benefits for a worker with medium earnings who retires in about 2042 at age 65?

Answer: Page 75 of the memorandum cited above indicated that we projected a basic Social Security benefit level that would be about 25.7 percent less than the current-law scheduled benefit for a retiree at 65 in 2042. Under current law with no change, it was estimated that 73 percent of benefits would be payable in 2042, for a reduction of about 27 percent.

Question: What would the cut be for a worker with medium earnings who retirees in about 2075 at age 65?

Answer: Page 75 of the memorandum cited above indicated that we projected a basic Social Security benefit level that would be about 45.9 percent less than the current-law scheduled benefit for a retiree at 65 in 2075. Under current law with no change, it was estimated that 67 percent of benefits would be payable in 2042, for a reduction of about 33 percent.

PRIVATE ACCOUNTS COST MONEY

Question: Many people believe that the diversion of payroll taxes into private savings accounts will reduce Social Security's and the Federal Government's costs. They are even stronger in this belief if this diversion is accompanied by an "offset." An "offset" is a mechanism in which the worker, in effect, gives back much of the money in his private account to the Federal Government at the time of retirement. It is my understanding that most private account proposals would actually cost the Federal Government money, even if the proposal contains an "offset." This would be true if the plan is evaluated over 75 years, or for that matter, over any finite time period.

Consider Model 2 as recommended by the President's Social Security Commission. The President has hinted that this is the plan he may propose to the Congress. Model 2 would allow workers to divert up to 4 percentage points of their Social Security payroll taxes into private accounts, with a cap of $1,000 per year. The plan also includes an "offset" at the time the worker retires.

Isn't it true that over 75 years, Model 2—even with the "offset"—would cost the Federal Government and also Social Security about $2 trillion in present-value terms?

Answer: Page 38 of the above-cited memorandum indicated that additional General Fund transfers were expected to be needed under Model 2 in years 2025 through 2054. The total present value of the expected transfers was about $1.4 trillion in present value.

By the end of 2075, publicly held debt was projected to be reduced by $18.9 trillion (constant 2001 dollars, see page 58) by Model 2 in total, and by $31.7 trillion (constant 2001 dollars, see page 57) for the basic provisions alone. The difference, an increase of about $12.8 trillion in constant 2001 dollars, may be attributed to the addition of the individual accounts and offsets to the Model. In present-value terms, this amounts to about $1.5 trillion.

Question: Doesn't the same phenomenon occur for Model 2 over any finite time period, either greater or less than 75 years?

Answer: Of course, the General Revenue Transfers to the trust funds to maintain solvency would all be expected to occur within the 75-year projection period under Commission Model 2. However, deficits for the unified budget balance would be expected to continue on an annual and cumulative basis even beyond the 75-year projection period, because the benefit offset yield rate for account holders (and due to inefficiencies in application of the benefit offset) would be expected to be less than the long-term Treasury bond yield.

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

Question: Proponents of individual accounts, including the President, have stated that a portion of payroll taxes that are placed in private accounts and are invested in the stock market will earn a considerably higher rate of return than that available from government bonds. If the President is asking the country to support a Social Security reform proposal that relies on higher projected returns in the stock market, then Congress must evaluate the proposal by reviewing a detailed description of their assumptions on stock returns.

The U.S. economy has grown at annual rate of approximately 3.4 percent over the past 75 years. Likewise, stocks have provided rates of return of about 7 percent over this same period. The Social Security Trustees Report, however, assumes that economic growth over the next 75 years will slow down to 1.6 percent of GDP, less than half the rate of growth we've actually experienced over the past 75 years, to support the projections in the Social Security shortfall.

Accordingly, if Social Security trustees project a significant slowdown in the growth in the economy from 3.4 percent to 1.6 percent over the next 75 years, what annual rate of return do you project investments of payroll taxes in the stock market will receive over the next 75 years?

Answer: Growth in aggregate GDP is based on the combination of the growth rate in the number of workers (and hours worked) and in the rate of growth in labor productivity (or output per hour worked). The trustees ultimate intermediate assumption for productivity is a real growth rate of 1.6 percent for the total economy (productivity is measured at a higher rate for the private non-farm business sector). Thus, the ultimate projection under intermediate assumptions is for an ultimate real growth rate of 1.8 percent for aggregate GDP. While the projected real growth rate in GDP is considerably lower than for the past, over long periods of time, this is due to the slower rate of growth in the working-age population and thus in the numbers of workers. Productivity, or output per hour worked, is assumed to continue at about the same rate as the long-term average for the past. The return to capital and the yield on investments is assumed to be more closely related to productivity growth than to the growth rate in the labor supply of the United States in the future. If the United States were a closed economy with a slowing growth rate in labor supply, we might expect an increase in capital per worker and a commensurate decline in the return to capital. However, because the United States is not at all a closed economy, and capital readily moves across national borders, we assume that this capital "deepening" will not occur to any substantial degree. Moreover, we believe that market forces will act to resolve the balance between the return to capital that is provided by business and industry and the return that is demanded by investors. This suggests that total investment in domestic corporations with domestic production will maintain roughly the same relationship to output as in the past. This assumption is consistent with the assumption that returns on equity investments will be not much different than in the past. Many have been concerned that due to high price to earnings ratios for equities around 2001, that future average equity yields would be lower than in the past. Price to earnings ratios were well over 40 at the time. Now these ratios are below 20 for the S&P 500 index, much closer to the long-term average of about 14. We believe that for many reasons, including greater access to equities by more people, the future price to earnings ratio will average slightly higher than in the past, and thus the overall yield on equities will be slightly lower than in the past. We assume a long-term future average annual real yield on equities of 6.5 percent. It is important to note that we do not mean this assumption to represent the expected yield over any period on a dollar invested starting at any particular point in time. Market cycles suggest that equities will be priced higher than average at some times and lower than average at other times. Our assumption is intended to represent the average expected yield for investments across many years over a relatively long period of time.

Question: Also, please provide a detailed description of the return on stocks you project will support the investment accounts, breaking down the projections, on a year-by-year basis, into dividend payouts and capital gains.

Answer: We do not make explicit projections of the components of returns on equities. The distribution of the total market return can be expected to vary over time. For example, if a company is expanding its workforce and production, as would be more common in a country with a rapidly growing population, more of the earnings of the company would be expected to be retained for further expansion of capital to accommodate the growing work force. In this case, relatively more of the total yield on equity holdings would come from increase in the market value of the equity share. If, on the other hand, employment and output growth slow, then relatively more of the total earnings of the company would be expected to be distributed to shareholders in dividends, or indirectly distributed through stock "buy-backs" by the company, thus increasing the value of the remaining outstanding shares. It would be very difficult to project with any certainty what the mix is for any group of companies, as the ability to expand operations abroad, where ample labor may be available, can create a disconnect between the actions of domestically-based corporations and the domestic economy.

RESPONSES TO QUESTIONS FROM SENATOR CRAPO

Question: My understanding of the Social Security trust fund is this: when Social Security collects more in payroll taxes than required to pay out in benefits, the government more or less spends this surplus in regular programmatic expenses, and then the government issues special bonds to account for having borrowed the funds.

- Is this accurate? If so, are the trust fund's special bonds better considered assets or liabilities?
- When Social Security surpluses begin to shrink in 2010, what are the expected impacts on the budget? And should we begin to prepare for these? Should all taxpayers be concerned about this date?

Answer: Whenever annual surpluses of Social Security tax revenue over program expenditures occur, these revenues are invested in financial securities backed by the full faith and credit of the United States government, as is required by law for all assets held in the Social Security trust funds. Currently all such "cash flow" surpluses are being invested in special issue obligations of the Treasury bearing market interest rates. What happens with the revenue from the purchase of such obligations of the Treasury depends specifically on the balance of operations of the rest of the Federal Government. If the rest of the Federal Government budget is in balance or surplus, then the revenue from the Social Security investments would effectively be used to reduce the amount of publicly held debt of the Federal Government. If the budget for the rest of the Federal Government is running an annual deficit, then the revenue from the Social Security investment would allow for a smaller increase in the amount of publicly held debt than would otherwise occur, and the specific revenue would thus effectively be used in that year to help finance other government expenditures in lieu of increasing publicly held debt.

In either case described above, the special Treasury obligations issued to the trust funds are backed by the full faith and credit of the United States Federal Government. The Federal Government has never failed to redeem such bonds in the past and is not expected to fail to do so in the future. Thus, these obligations are assets of the Social Security program by any meaning of the word. However, the special obligations are equally liabilities of the Treasury and represent commitments to redeem these obligations, with interest, when needed by the Social Security trust funds.

The nominal dollar level of Social Security annual cash flow surpluses (excess of tax revenue over program expenditures) is expected to begin to decline in 2009 under the intermediate projections of the 2005 Trustees Report. This will have no effect on the "on-budget" balances of the Federal Government, which exclude the operations of the Social Security trust funds. However, the surpluses from the Social Security program will, at that time, begin to provide a declining source of borrowing for the rest of the Federal Government, thus meaning that increases in publicly held debt will be larger, or decreases in publicly held debt will be smaller than if Social Security had annual surpluses that did not decline.

The diminishing of annual cash flow surpluses for the Social Security program starting around 2009 will be gradual. Implications for increased levels of publicly held debt as a result should be considered in the development of the budget for the rest of the Federal Government. Because borrowing from the trust funds represents a liability of the Treasury just as does borrowing from the public, it is not clear what distinction the financial markets make between these two types of borrowing. Thus, it is not clear whether, for any specific level of on-budget balance, the size of annual Social Security surpluses has an impact on the financial markets. What is clear is that the extent of on-budget deficits and borrowing does have an effect on the economy and the financial markets, and that deficits are not generally desirable, regardless of how they are financed. It does not appear that the amount of such on-budget deficits that can be financed with borrowing from the trust funds should be the principle concern of the tax payers.

The commitments of the Treasury represented by assets held in the Social Security trust funds will begin to grow less rapidly in 2009 and are likely to be needed by the program, at least in part, in subsequent years. Thus, the best preparation for this appears to be a reduction in the size of publicly held debt of the Treasury between now and the time when net redemptions of Social Security assets will begin, around 2017.

Question: According to CBO (SSA) analysis, outlays will exceed revenue in 2020 (2018); thereafter the Trust Fund's bonds will have to be redeemed to pay for retiree benefits. But by Social Security redeeming these bonds, the U.S. Treasury is forced to figure out a way to come up with the money to pay for these bonds. Suffice it to say, the Treasury, and Congress, isn't always the best at finding ways to save money.

Under current assumptions, how much money would the Treasury be responsible for "coming up with" starting in 2020 (2018)?

Answer: Under the intermediate projections of the 2005 Trustees Report, Social Security expenditures will begin to exceed tax income (excluding interest earned on the trust fund assets) beginning in 2017. Such redemptions are projected up to the point of trust fund exhaustion, which on a combined basis is expected to occur in 2041. After trust fund exhaustion, no further redemptions are possible under current law, and thus the Treasury would have no further liability. The projected level of Social Security annual "balance," which represents net redemptions of trust fund assets by the Treasury for years 2017 through 2040, is available in current dollars in Table VI.F9 of the 2005 Trustees Report, which can be found for single years in the future at *http://www.ssa.gov/OACT/TR/TR05/lr6F9-2.html*. Values for years after 2040 are theoretical differences between the cost of providing benefits scheduled in the law and scheduled tax revenue. Because the trust fund assets are projected to be exhausted after 2040, the subsequent negative balances represent reductions in Social Security expenditures that would be needed if no changes are made, rather than continued redemptions by the Treasury.

Question: You have said before that the sooner we act to address Social Security's long-term outlook problem, the more options we have.

- Can you please describe what kind of choices and options will disappear the longer we wait to fix the current system? Can you actuarially describe what it means to the Social Security system and to our economy to wait?
- When we analyze different reform proposals, how important is it to pay close attention to what is known as "sustainable solvency?"

Answer: Answering the second question first, attention to "sustainable solvency" depends on the goal of the reform proposal. Achieving sustainable solvency requires not only that solvency be projected for the Social Security program throughout the 75-year projection period, but also that the financing of the program be on a sustainable basis at the end of the period, under the intermediate projections. This means that the projected trust fund levels expressed as a percentage of program cost be positive throughout the 75-year projection period and either stable or rising at the end of the period. If achieved, this means that solvency can be expected for the foreseeable future.

The desirability of achieving sustainable solvency is clear if we want to minimize the chance that major reform will be needed in the future based on financial shortfalls. The well known amendments of 1983 satisfied the 75-year solvency criterion, but not the stable or rising "trust fund ratio" criterion. Thus, those amendments would not have met sustainable solvency at that time. The choice of whether to fully satisfy these criteria is in the hands of the Congress.

Even meeting sustainable solvency under the intermediate projections of the Trustees Report, however, cannot be said to guarantee that solvency will be restored permanently. Due to the uncertainty of the future, a proposal that just meets the criteria for solvency or sustainable solvency has about a 50-percent chance that, in fact, some future changes over those expected under the current immediate projections will be needed. And even a plan that would have substantial surpluses under the intermediate assumptions cannot guarantee permanent solvency. Permanent solvency can only be assured through automatic mechanisms such as a provision to provide transfers from the General Fund of the Treasury whenever needed to maintain solvency. Such provisions exist for the Medicare Part B program, for example, and are also included in many proposals like Models 2 and 3 of the President's Commission to Strengthen Social Security. Without such automatic provisions, solvency cannot be said to be permanent.

In regard to restoring solvency, and sustainable solvency, for the Social Security program, most proposals have principally targeted changes in revenue and benefit levels to eliminate the shortfalls, or annual deficits, of the program for the years in which these deficits occur after the point where the trust funds would otherwise have become exhausted. As the time at which these deficits are projected to occur is still many years in the future, the size of changes needed to correct them is not expected to change significantly whether they are enacted into law this year or next year or the year after.

For example, based on the intermediate assumptions of the 2005 Trustees Report, eliminating the deficit for the year 2042, the first full year after trust fund exhaustion, solely with reductions in scheduled benefits would require a reduction of about 26 percent. Whether enacted now or next year, the magnitude of the reduction needed to accomplish this result is expected to be the same.

The disadvantage of delaying substantially the enactment of changes that will restore solvency and sustainable solvency for Social Security are three. First, with greater delay, any enacted changes will likely provide less advance notice to those workers and beneficiaries who will be affected. Second, if enactment is delayed very substantially, then the ability to phase in any changes gradually so as to avoid abrupt changes in benefit levels or revenue changes will be diminished. Third, if enactment is delayed substantially, then options will become progressively more limited. At the extreme, if enactment were delayed until 2041, options would be limited essentially to a virtually immediate reduction in benefit payments of around 26 percent for all beneficiaries, a virtually immediate increase in revenue equivalent to about 4.3 percent of payroll or about 1.5 percent of GDP, with larger changes thereafter. Delays in enactment of only 1 or a few years would have far less drastic consequences.

Question: Should any "transition costs" of any reform plan be considered to be real costs; or are "transition costs" more simply accounting changes, in which off-balance sheet obligations of the government (that is, the "promises" made under the current system) are exchanged for on-balance sheet debt?

Answer: Social Security is currently projected to have substantial unfunded obligations for the future. Under the intermediate projections of the 2005 Trustees Report, these unfunded obligations over the 75-year long-range projection period are equivalent to about 1.8 percent of the payroll tax base and 0.6 percent of GDP over the 75-year period as a whole. However, these unfunded obligations are not liabilities of the Social Security trust funds or of the Federal Government. If no action is taken (and the intermediate assumptions of the Trustees are realized), these unfunded obligations will simply not be met based on current law. Benefits scheduled in the law which cannot be met with assets in the trust funds cannot be paid. These scheduled benefits do not represent "promises," but rather intended levels of benefits assuming financing is sufficient. Thus, any change that would increase the actual revenue to the Social Security program from that provided in current law and would permit additional benefit payments does represent a real effect and not just an accounting change.

RESPONSES TO QUESTIONS FROM SENATOR KYL

Question: If Congress tries to head off the shortfall by increasing the tax rate or by raising or eliminating the wage base cap, to what extent would we defeat our purpose owing to the corresponding increase in high-income earners' benefits that would occur once payroll tax deductions increased?

Answer: As an example, complete elimination of the Social Security taxable maximum (contribution and benefit base) without any credit for higher benefits is projected to reduce the annual deficit of the program in 2079 by about 2.9 percent of payroll, or by one-half the current projected deficit of 5.7 percent for 2079. If credit is provided for the additional taxable earnings in the current benefit formula, then the annual deficit would be reduced by about 1.9 percent of payroll, or by about two-thirds as much. Over the 75-year long-range period as a whole, the elimination of the taxable maximum without additional benefit credit would improve the actuarial balance by about 2.2 percent of payroll, more than fully eliminating the 75-year shortfall of 1.92 percent. If benefit credit were provided, then the improvement in the actuarial balance would be about 1.75 percent of payroll, largely but not completely eliminating the 75-year deficit. It is important to note that in either case the elimination of the taxable maximum does more for improving the financial status for the 75-year period as a whole than it does for the annual imbalance of the program at the end of the period, and thus for achieving sustainable solvency.

Question: If Congress disconnected benefits from taxes paid in this fashion—converting the current social insurance program to a welfare program—by how much would we have to either increase the payroll tax rate or increase/eliminate the cap to pay promised benefits?

Answer: Complete elimination of the taxable maximum without any additional benefit credit would be expected to permit full payment of benefits scheduled in current law through the 75-year projection period (through 2079) and for roughly a decade or so beyond, under the intermediate assumptions of the 2005 Trustees Report. However, because the annual deficits at the end of the 75-year period would be reduced from around 5.7 to 2.8 percent of payroll, or by about half, continuing deficits would result in declining trust funds as a percentage of annual program cost, and thus sustainable solvency would not be met.

Responses to Questions From Senator Lincoln

SOCIAL SECURITY TRUST FUND

Question: For the last 2 decades we have borrowed from the Social Security trust fund and spent that money in the general fund. Approximately $1.5 trillion plus interest is owed to the Social Security system by the general fund. Is that correct?

Answer: Yes, and in fact the value of Social Security trust fund assets has increased to $1.7 trillion dollars as of the beginning of this year.

Question: How do you think the government is going to pay for that?

Answer: The combined Social Security trust funds are projected to continue to run positive cash flows through 2016. Starting in 2017, under the intermediate assumptions of the 2005 Trustees Report, it is projected that net redemption of assets held by the trust funds will be necessary to augment tax income for the purpose of fully paying scheduled benefits in the law. If there is no change in Social Security and such net redemptions are needed starting in 2017, then the government will generate the revenue needed to redeem the bonds either with excess revenue from on-budget surpluses at the time, or through the issuance of additional debt to the public, if there are not sufficient on-budget surpluses.

Question: The headline from a recent article in the *Financial Times* read "Central banks shun U.S. assets." The article says that central banks are "shifting reserves away from U.S. assets and towards the eurozone," which could undermine the dollar's value on currency markets. What happens if no one wants to buy our debt? Would we have any other alternative other than turning to the American people to take on this debt?

Answer: It is unlikely that we would ever reach a point where no one would want to invest in United States government securities. However, the strength of the dollar and the economy will play a role in determining the rate of interest that the government will need to provide to attract sufficient lenders. The alternative to increasing Federal debt is to have unified budget balance by having tax revenue for the government as a whole sufficient to cover current spending needs, including service on the debt.

Question: How much would we have to raise the income tax to cover saving the Social Security surplus rather than spending it on the general fund?

Answer: If non-Social-Security taxes were raised or non-Social-Security spending reduced sufficient to produce on budget balance, then the projected cash flow surplus for Social Security through 2016 would result directly in reductions in the amount of publicly held Federal debt.

Question: If we borrow money at interest to create individual savings accounts and we have to borrow that money from foreigners and pay them interest with our taxes—aren't we actually lowering the net savings in America?

Answer: In the scenario described, net savings each year would be essentially the same. The Federal Government would be borrowing from abroad, and the American people would be saving that revenue. The extent to which there would be any change would depend on numerous factors, such as the extent to which Americans modified their other saving in response to the accounts, and the relative interest rates realized on both investments.

HEALTH CARE COSTS RELATIVE TO SOCIAL SECURITY

Question: I understand that Federal spending for Medicare is rising at a much faster rate than Federal funding for Social Security. As a matter of fact, Medicare costs will exceed Social Security costs in 2024 and will be twice as much as Social Security by the year 2078. In addition, the Medicare Health Insurance Trust Fund will be insolvent in 2019 as opposed to the Social Security trust fund which will be solvent until 2042 (or 2052 according to CBO).

I am not trying to negate the fact that Social Security is facing a long-term financial challenge that needs to be addressed, but if you were to prioritize these, it seems to me that rising Medicare/health care costs are a bigger issue. Would you like to comment?

Answer: Clearly both Medicare and Social Security face substantial financial challenges for the future, with a common base cause in the demographic shifts due to lower birth rates and continued increase in life expectancy. The desire to provide solutions that can be phased in gradually and also provide advance notice to those affected suggest that addressing both of these projected financial shortfalls relatively soon would be advantageous.

Question: What are our options for dealing with these rising costs other than raising taxes, increased borrowing, or cutting benefits?

Answer: These are three of the principal measures that are available for addressing the projected financial shortfalls. One additional measure is increasing the retirement age which may be categorized as a reduction in benefit level. Another option is to establish a greater degree of advance funding for the program, either directly in the trust funds or indirectly in individual accounts. However, in order to develop advance funding for the long run, additional revenue is needed in the near term through one of the three approaches mentioned.

PERSONAL SAVINGS

Question: It is important that we find a way to increase individual and household savings in the U.S. Currently, there is a net negative savings rate in this country, meaning people owe more money than they're saving. What effect do we expect private accounts to have on increasing savings? Furthermore, what other options should be examined as a way to accomplish this goal?

Answer: The true net effect on personal saving of individual accounts is unclear and may depend on the nature of the accounts. Establishing a national vehicle for such accounts may have the effect of creating a savings culture among at least some Americans that would cause them to save all the new account as additional savings and perhaps even more. For others, the knowledge of the new asset in the accounts might cause them to save less elsewhere, particularly if they feel they are already saving enough. Even for low earners who may now have no savings, there might be a tendency to increase consumer debt in recognition of the account savings. On a national perspective, whether accounts result in more net saving will also depend on how the contributions are financed. If account contributions are financed by the Federal Government through issuance of more debt, there may be no increase in national savings or even a decrease to the extent that individuals decrease other personal savings. If accounts are financed from out-of-pocket contributions by individuals, savings will be increased again only to the extent that other savings or contributions to retirement plans are not reduced. Estimates produced by the Office of the Chief Actuary incorporate an assumption that there will be no net increase or decrease in savings.

SOLVENCY

Question: We know that introducing private accounts alone will not ensure the solvency of Social Security. In fact, it would move up the 2018 date by 10 years, to 2008. Although it may increase returns on assets, it does so at the cost of additional risk. Furthermore, it seems to me that any program that would divert money from the current system would make our problem worse. What role do private accounts alone play in solving the 75-year financial shortfall?

Answer: Model 2 under the President's Commission changed the date at which Social Security outgo would exceed tax income from 2016 to 2010 under the intermediate assumptions of the 2001 Trustees Report (see page 38 of actuarial memorandum *http://www.ssa.gov/OACT/solvency/PresComm_20020131.pdf*). Diverting trust fund revenue for individual account contributions does indeed diminish the asset holdings, and even on a complete-cohort basis including subsequent benefit offsets, the trust funds would be diminished. However, under that plan, trust fund solvency would be assured by providing general revenue transfers as needed. In addition, near-term reductions in trust fund assets would be essentially matched by balances in the individual accounts. Thus, "total system assets," defined as the sum of assets in the trust funds, the individual accounts, and the annuities based on individual accounts, would tend to be about the same as the trust funds would be with the addition of transfers required under Model 2. The potential advantages of the individual accounts are three. First, they represent one way to incorporate some advance funding into the system. Second, they may provide an opportunity for individuals to increase their retirement income, offsetting some or all of the other effects on scheduled Social Security benefits. And third, once the additional revenue is committed for creation of individual accounts as an advance funding mechanism, future net cash flow effects for the trust funds can be expected to be positive, as Social Security benefit offsets based on the accounts in a given year will generally be greater than the expenditures to finance account contributions for then-current workers.

PRICE INDEXING

Question: As has been noted, current law ties initial benefits to wages. A recent memo from the Bush Administration has argued on behalf of price-indexing, a process that would adjust benefits to the rise in inflation. It is estimated that a change of this magnitude would result in a 46-percent benefit cut for a person retiring in 2075. In today's dollars, an average wage earner who began working in 1962 and retired in 2005, would receive nearly $400 less a month in benefits. According to Model 2, this reduction would happen whether you chose to participate in the private account or not.

Wouldn't this dramatic reduction put more people in poverty?

Answer: Any assessment of how many more or less people would be in poverty requires a careful assessment of all the effects of implementing a proposal in relation to the specific circumstances expected in the absence of the implementation. If the comparison of the effect is relative to current law with scheduled benefits fully financed, the answer would be different from the comparison to benefit levels payable under current law, or those payable with the transfers required under Model 2 added to the current trust funds. Even if the expected returns on accounts indicates that total expected benefits will be over the poverty level, variation on account returns would still result in poverty in some cases, but higher than expected benefits in other cases. Poverty would be expected to be higher among those who did not choose accounts, eventually, because price-indexed benefits across generations would produce benefits that were ultimately lower than the benefits payable from Social Security under current law. However, even this effect might be mitigated with provisions like "low earner enhancements" such as those included in Commission Models 2 and 3.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: Last week, I was in West Virginia with a group of seniors, most of them in their late 60s and 70s. They were very worried about the current Social Security program and their benefits.

Isn't it true that the current system can pay benefits through 2018 based on payroll taxes, and then pay benefits until 2042 by tapping into the Social Security Trust Funds?

Answer: Yes, based on the intermediate projections of the 2004 Trustees Report. The intermediate projections of the 2005 report indicate that these two dates are now expected to be 1 year earlier, in 2017 and 2041, respectively. These new dates in fact are the same as were projected for the 2002 Trustees Report. So these dates should be taken as indications of what is likely, given our current knowledge, and not as firm predictions.

Question: Aren't the securities in the trust funds backed by the full faith and credit of the U.S. government? Has our government ever defaulted on our bonds?

Answer: Yes, they are so backed. No, there has never been a default, and we do not believe that there will be.

Question: In addition to retirement benefits, many West Virginia families—almost 40 percent—rely on disability benefits or survivors benefits. What happens to funding for these insurance programs, if one-third of payroll taxes are diverted to private accounts?

Answer: This depends on the nature of the proposal being considered. Some proposals, in order to restore solvency for Social Security, reduce the basic benefit formula from that scheduled in the law. This reduction might or might not apply to disability beneficiaries. Generally, access to individual accounts is not permitted until retirement, and no offsets based on account participation are applied until retirement, that is, until after reaching retirement age by disabled workers. But the specifics change across proposals.

Question: Social Security solvency is usually measured in terms of 75 years. The President has recently begun talking of the need to measure Social Security's solvency into infinity. I recognize that we must take a long view of Social Security solvency in order to protect the benefits for future generations. But can you please tell me whether measuring Social Security's solvency over an infinite horizon is reliable or credible?

Answer: In theory, projections can be made that extrapolate into the infinite future. The Trustees Report has included such extrapolations since 2003 on an aggregate "unfunded obligation" basis. These extrapolations should be viewed as considerably more uncertain even than are estimates for 75 years into the future. Long-range projections have traditionally been made for 75 years because this time period (1) encompasses the remaining lifetime of virtually all of the current participants in the program, (2) allows for the full phase-in of expected future economic and demographic trends, and (3) it is a period long enough to illustrate the fully matured effects of proposals that phase in over time.

Question: When making extremely important policy decisions, how much confidence can Congress have in projections more than 75 years into the future?

Answer: Clearly, specific projections much beyond 75 years become increasingly uncertain. For this reason, we developed, over 10 years ago, the concept of sustainable solvency to address concerns over the prospect for reform that would restore solvency through the 75-year period but would lead to insolvency shortly thereafter. Sustainable solvency has two criteria. One is solvency through 75 years, meaning trust fund levels are positive throughout the period and thus benefits scheduled would be expected to be fully payable. The second criterion is that that these trust fund levels, expressed as a percentage of annual program cost, are projected to be stable or rising at the end of the 75-year long-range projection period. These criteria, if met, will lead us to reasonably conclude that the solvency of the program is sustainable for the foreseeable future. This does not mean that additional adjustments will in no case be required during and beyond the 75-year projection period. Uncertainty cautions us to recognize that changing conditions may well cause actual results to turn out either more or less favorably than projected under the intermediate assumptions.

RESPONSE TO A QUESTION FROM SENATOR SCHUMER

Question: There's one thing that's really bothering me about this rush to privatize Social Security, particularly given Dr. Holtz-Eakin's testimony that the program is essentially sustainable in its current form, with minor changes. Back in 2001, the President used CBO's 10-year projected budget surplus to argue for his tax cuts, even though he was warned that the budget projections were unreliable and uncertain. Even Alan Greenspan said we should place a "trigger" on the tax cuts due to budget uncertainty. Once the budget returned to deficit, the Administration then argued that 10-year projections were, "not worth the paper they're printed on."

Now with Social Security, we're faced with projections that aren't 10 years into the future, but 40 and 50 years into the future. Given the uncertainty of such projections, do you believe that it would be more prudent to make incremental changes, and then come back in another 10 or 20 years if we need to tweak the program further, rather than attempting to partially privatize the system?

Answer: The projected cost and income of the Social Security program are indeed uncertain, but less so than for most programs due to the specific benefit entitlement criteria and the benefit formula used. The system responds to a large degree to changes in wage levels in the future. In addition, changes due to demographic effects, the most important of which is the shift since 1972 to sustained lower birth rates, are relatively well understood and reasonably foreseeable through 75 years. The vast majority of beneficiaries through this period are already born. Therefore, projections for this period provide a reasonable basis for making changes that would be expected to restore solvency through at least 75 years. Changes to do so would be useful in reassuring workers, especially younger workers, that Social Security will be there for them, even if in a modified form. Moreover, the changes in the population and thus in the cost of the program make it clear that changes will be needed to maintain solvency. It would therefore seem to be desirable to enact amendments to restore solvency for the long-range 75-year period, whether these include individual accounts or not. In doing so we hope that the Congress will strongly consider meeting the criteria for sustainable solvency, which further call for trust fund levels at the end of 75 years that are stable or rising as a percentage of the cost of the program. Meeting these criteria would allow us to state that solvency is expected for the foreseeable future, with at most relatively modest future adjustments.

PREPARED STATEMENT OF HON. DOUGLAS HOLTZ-EAKIN

Chairman Grassley, Senator Baucus, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss the Social Security program from three perspectives: economic, budgetary, and programmatic. Those perspectives illuminate some of the policy issues that arise as the United States confronts the aging of its population.

First, Social Security can be viewed through the lens of the economy. Beneficiaries make decisions about when to retire and how much to work before retirement partly on the basis of the amount of taxes they pay and the amount of benefits they expect to receive. Social Security also influences people's decisions about how much to save, which plays a role in determining the size not only of their retirement income but also of the nation's capital stock as a whole. Consequently, Social Security has important implications for aggregate economic performance—for the flow of income that the economy will be able to generate and for the total stock of wealth and overall economic resources that will be available in the future. As a result, Social Security can significantly affect the nation's standard of living as well as the distribution of income within and among generations.

Second, from a budgetary standpoint, Social Security is the single largest program of the federal government. This fiscal year, outlays for Social Security are expected to top $500 billion and account for 23 percent of total federal spending (excluding interest). Looking farther ahead, the Congressional Budget Office (CBO) projects that Social Security outlays will grow from 4.2 percent of gross domestic product (GDP) in 2005 to 6.5 percent in 2050. Although that growth is significant, it pales in comparison with the projected growth of the government's two big health programs, Medicare and Medicaid.

Last, Social Security can be analyzed from the perspective of the program itself. The most recent programmatic focus has been on the "sustainability" of the system's finances. However, several other aspects of the program are also important. Throughout its long history, Social Security has had multiple goals—some related to redistributing income, others to offsetting lost earnings. In 2004, only about two-thirds of Social Security's beneficiaries were retired workers; the rest were disabled workers, survivors of deceased workers, and workers' spouses and minor children. Policymakers will need to decide whether the program's goals are still appropriate, and if so, how changes to Social Security would aid or hinder the achievement of those goals and affect various types of beneficiaries and taxpayers. Those decisions will also need to take into account the dramatic increase in the elderly population that is expected in coming decades.

My statement examines the prospects for Social Security from each of those three perspectives, in reverse order, beginning at the programmatic level.

The Outlook for the Social Security Program

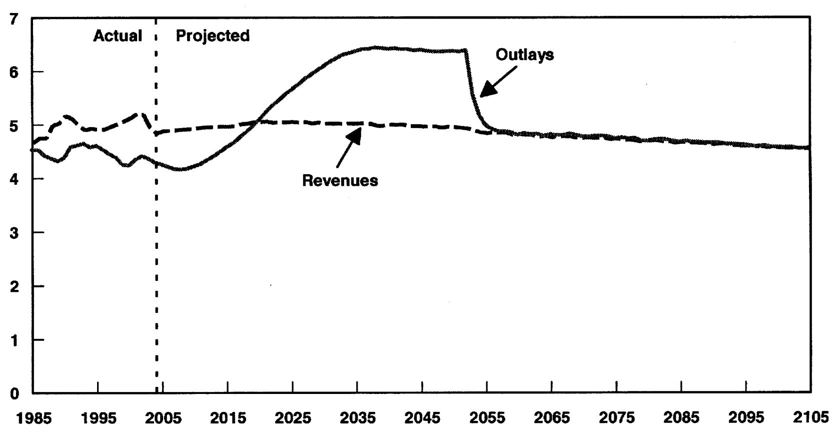
Although there is significant uncertainty involved in making numerical projections of the future of Social Security, the basic trajectory is widely accepted. The outlook for the Social Security program is generally the same regardless of whether one turns to the long-term projections of Social Security's trustees or to those of the Congressional Budget Office.

A key date for the program is 2008, when the leading edge of the baby-boom generation will become eligible for early retirement benefits. Shortly thereafter, the annual Social Security surplus—the amount by which the program's dedicated revenues exceed benefits paid—will begin to diminish (see Figure 1). That trend will continue until about 2020, when Social Security's finances will reach a balance, with the revenues coming into the system from payroll taxes and taxes on benefits matching the benefit payments going out. Thereafter, outlays for benefits are projected to exceed the system's revenues. To pay full benefits, the Social

Figure 1.

Social Security Revenues and Outlays as a Share of GDP Under Current Law

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenues in 2020; starting in 2053, the program will no longer be able to pay the full amount of scheduled benefits.

Security system will eventually have to redeem the government bonds held in its trust funds. But where will the Treasury find the money to pay for those bonds? Will policymakers cut back other spending in the budget? Will they raise taxes? Or will they borrow more?

In the absence of other changes, the redemption of bonds can continue until the trust funds are exhausted. In the Social Security trustees' projections, that happens in 2042; in CBO's projections, it occurs about a decade later, largely because CBO projects higher real interest rates and slightly lower benefits for men than the trustees do. Once the trust funds are exhausted, the program will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although there is some uncertainty about the size of that reduction, benefits would probably have to be cut by 20 percent to 30 percent to match the system's available revenue.

The key message from those numbers is that some form of the program is, in fact, sustainable for the indefinite future. With benefits reduced annually to match available revenue (as they will be under current law when the trust funds run out), the program can be continued or sustained forever. Of course, many people may not consider a sudden cut in benefits of 20 percent to 30 percent to be desirable policy, but it is sustainable from a financing perspective.

What is not sustainable is continuing to provide the present level of scheduled benefits (those based on the benefit formulas that exist today) given the present financing. Under current formulas, outlays for scheduled benefits are projected to exceed available revenues forever after about 2020 (see Figure 2). That gap cannot be sustained without continual—and substantial—injections of funds from the rest of the budget.

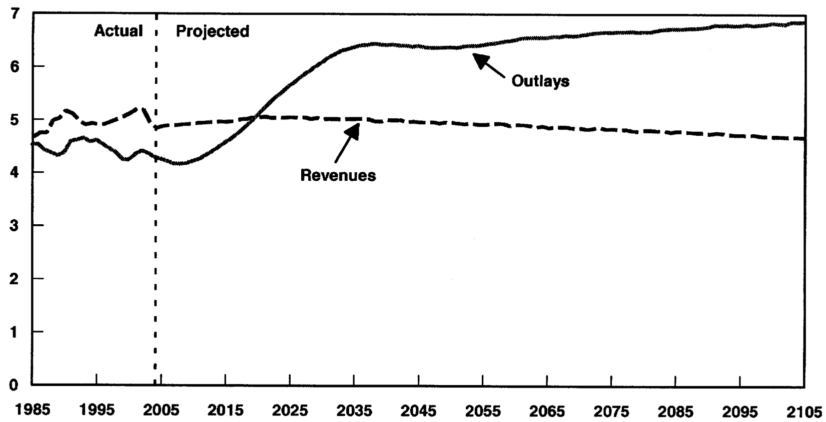
The Impact of Social Security on the Federal Budget

I would like to make two points about Social Security in the larger context of the total budget. First, Social Security will soon begin to create problems for the rest of the budget. Right now, Social Security surpluses are still growing and contributing increasing amounts to the rest of the budget. But as explained above, those surpluses will begin to shrink shortly after 2008, when the baby boomers start to become eligible for early retirement benefits. As the rest of the budget receives declining amounts of funding from Social Security, the government will face a period of increasing budgetary stringency. By about 2020, Social Security will no longer be contributing any surpluses to the total budget, and after that, it will be drawing funds from the rest of the budget to make up the difference between the benefits promised and payable under current law and the system's revenues. Policymakers will have only three ways to make up for the declining Social Secu-

Figure 2.

Social Security Revenues and Outlays as a Share of GDP with Scheduled Benefits Extended

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure is based on a simulation from CBO's long-term model using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. In this simulation, currently scheduled benefits are assumed to be paid in full after 2053 using funds from outside the Social Security system.

rity surpluses and emerging Social Security deficits: reduce spending, raise taxes, or borrow more.

CBO's projections offer some guidance about the potential impact of those developments on the budget. By CBO's calculations, the Social Security surplus (excluding interest) will reach about $100 billion in 2010. But by 2025, that surplus is projected to become a deficit of roughly $100 billion (in current dollars). That $200 billion swing will create significant challenges for the budget as a whole.

Second, the demand on the budget from Social Security will take place simultaneously with—but be eclipsed by—the demand generated by Medicare and Medicaid. Currently, outlays for Social Security benefits equal about 4 percent of GDP, as does federal spending on Medicare and Medicaid. But whereas Social Security outlays are projected to grow to almost 6.5 percent of GDP by 2050, spending on the two health programs is expected to grow substantially more. Over the past few decades, excess growth in health care costs—the extent to which per-beneficiary health care costs increase faster than per capita GDP—has been about 2.5 percent annually. If that trend is extrapolated, federal spending on Medicare and Medicaid will rise from about 4 percent of GDP now to about 20 percent in 2050, which is roughly the current size of the entire federal budget. If one assumes a fairly dramatic shift to a slower increase in health care costs—that excess cost growth will decline to less than half of its historical rate—federal spending on Medicare and Medicaid will still roughly triple by 2050, to 12 percent of GDP. The clear message is that while Social Security will place demands on the federal budget, those demands will coincide with much greater demands from Medicare and Medicaid.

Social Security and the Economy

Although looking at the overall budgetary context is important, Social Security and its possible reform also carry significant implications for the economy and economic policy.

One of the major achievements of reform could be to resolve uncertainty about the future of the program. Uncertainty is an economic cost in its most fundamental form, and in the current context, there is uncertainty about the future of Social Security, its configuration, and who will be affected. The sooner that uncertainty is resolved or reduced, the better served will be current and future beneficiaries, who must make various decisions about their retirement (from how much they should save to when they will be able to stop working).

A key uncertainty stems from a central policy question: to what extent should the Social Security program in the 21st century resemble the program in the 20th century? There are two separate aspects to consider: insurance and financing.

In terms of insurance, the major issue is finding the appropriate balance between social responsibility and individual responsibility. On one side, some people argue that the nation needs a program of universal social insurance that allows for the redistribution of resources among individuals and provides a hedge against such adverse outcomes as poor health, unemployment, low wages, or simply having bad luck. On the other side, some people argue that it would be better to have a retirement system that relied more on individuals (which proponents view as desirable in itself) and included provisions that strengthened incentives for individuals to work and save.

In terms of financing, the major issue is striking the appropriate balance between prefunding retirement (with each generation saving for its own retirement) and employing a traditional pay-as-you-go method of financing (in which assets are not accumulated, but instead current revenues are used to finance benefit payments to retirees). Prefunding retirement benefits has the potential to increase the nation's capital stock, boost productivity, and raise GDP in the long run. However, prefunding requires some people to consume less or work more than they would otherwise during a transitional period.

Although prefunding could be carried out either by having individuals save more or by having the government save more (through smaller budget deficits or larger budget surpluses), analysts disagree on the extent to which the government could actually prefund retirement benefits, for several reasons. The experience of recent years, for instance, raises questions about the likelihood that the government would be able to maintain budget surpluses for long periods of time.

Regardless of one's views about those issues, any approach to Social Security will have to confront the new demographic situation—low fertility rates, declining mortality rates, and changing patterns of marriage, divorce, participation in the labor force, and immigration—as well as a host of other factors that are very different now than they were in the past. Reconfiguring Social Security to reflect those new realities, and better insulating the system from unexpected demographic or economic changes, will be a major challenge for policymakers.

RESPONSES TO QUESTIONS FROM SENATOR GRASSLEY

Question: In December 2003, CBO projected individual income tax liabilities under both current law and under a permanent extension of EGTRRA and JGTRRA for the period 2003 through 2050. Could you provide the Committee with an update of these projections and extend the time period through 2105?

Answer: We have not reestimated the cost of a permanent extension of EGTRRA and JGTRRA through 2050. The Joint Committee on Taxation has updated estimates of extension though 2015, and those amounts were published in Table 4–10 of our January 2005 Budget and Economic Outlook. As of 2015, the extension of the personal income tax provisions of EGTRRA and JGTRRA would lower revenues by 1 percent of GDP. We expect to release updated estimates in our *Long-Term Budget Outlook* at the end of this year, and it will contain updated estimates for years beyond 2015.

Question: In July 2004, CBO projected the 80 percent confidence interval for the ratio of lifetime benefits to lifetime taxes by birth cohort under current law and Plan 2 (as displayed in Figures 4A to 4C of the report). Could you provide the committee with the data used to construct these charts, as well as the median values for each of the simulations?

Answer: The data for the 10th and 90th percentiles presented in the figures are available on CBO's website, in the "supplemental data" attachment to the analysis (see *www.cbo.gov/Spreadsheet/5666_Data.xls*, sheets "Data for Fig. 4A," "Data for Fig. 4B," and "Data for Fig. 4C.") The median values are given in the attached spreadsheet.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: Are risk-adjusted returns for stocks higher than returns from treasury bonds?

Answer: CBO uses the market's valuation of risk to adjust returns for stocks. Using market prices ensures that, by definition, risk-adjusted returns for stocks are exactly equal to those of bonds.

Question: Mr. Holtz-Eakin, I would appreciate it if you could just confirm one concept for me. As I read your report, you are saying that in essence a dollar is a dollar, and once you take risk into consideration, stocks do not provide any higher expected return than risk-free bonds.

Thus, would it be fair to say that an investment of money from a private account in stocks would not be expected to make the account-holder better off than an investment of such money in bonds?

Answer: Yes. At the point of purchase, the individual would be neither better nor worse off. At that time, a dollar of stocks is worth a dollar of bonds. Although stocks are expected to earn higher returns over time than bonds, they also carry higher risks. When deciding to purchase a stock or bond, investors weigh the trade-offs between risk and return. Financial markets adjust the prices of the two assets until investors are indifferent about whether to hold one asset or the other.

PRICE-INDEXING WILL CAUSE DEEP BENEFIT CUTS

Question: Model 2 of the President's Social Security Commission would switch the calculation of initial Social Security benefits from wage-indexing to price-indexing. This would result in deep cuts in initial benefits.

1. Mr. Holtz-Eakin, could you tell me the size of the percentage cut for initial Social Security benefits for a worker with median earnings in the middle household income quintile who retires in about 2045 at age 65?

2. What would the cut be for a worker with median earnings in the middle household earnings quintile who retires in about 2075 at age 65?

Answer: CBO projects that under current law ("trust-fund financed"), first-year benefits for the cohort born in the 1980s—who will turn 65 from 2045 through 2054—will be $20,500 (in 2004 dollars).

If benefits were indexed so that average benefits grew at the same rate as prices, the median first-year benefit for that group would be $13,600, 34 percent lower than under current law.

The equivalent values for the cohort born from 2000 through 2009, who will turn 65 in 2065 through 2074, are $20,100 under current law and $13,500 if benefits grew with prices, or 33 percent lower.

PRIVATE ACCOUNTS COST MONEY

Question: Many people believe that the diversion of payroll taxes into private savings accounts will reduce Social Security's and the Federal Government's costs. They are even stronger in this belief if this diversion is accompanied by an "offset." An "offset" is a mechanism in which the worker, in effect, gives back much of the money in his private account to the Federal Government at the time of retirement. It is my understanding that most private account proposals would actually cost the Federal Government money, even if the proposal contains an "offset." This would be true if the plan is evaluated over 75 years or for that matter, over any finite time period

Consider Model 2 as recommended by the President's Social Security Commission. The President has hinted that this is the plan he may propose to the Congress. Model 2 would allow workers to divert up to 4 percentage points of their Social Security payroll taxes into private accounts, with a cap of $1,000 per year. The plan also includes an "offset" at the time the worker retires.

1. Isn't it true that over 75 years, Model 2—even with the "offset"—would cost the Federal Government and also Social Security about $2 trillion in present value terms?

2. Doesn't the same phenomenon occur for Model 2 over any finite time period, either greater or less than 75 years?

Answer: In a system where funds are diverted into individual accounts and benefits are offset later, there is always a delay between any increase in unified deficits, in the form of outlays to the accounts, and decreases in deficits, in the form of reduced benefit outlays. If the present value of reduced benefits is less than or equal to the present value of the funds redirected to the accounts, the presence of the accounts will result in an increase in the Federal debt at any point in time.

However, Plan 2 included other provisions that resulted in lower deficits or a larger surplus. The proposal as a whole would initially result in lower total budget balances (either larger deficits or smaller deficits), but CBO estimated that the median annual budget balances would be higher than under current law beginning in 2067. Over 75 years, the present value of budget balances would be about $400 million lower under Plan 2 than under current law.

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

Question: Proponents of individual accounts, including the President, have stated that a portion of payroll taxes that are placed in private accounts and are invested in the stock market will earn a considerably higher rate of return than that available from government bonds. If the President is asking the country to support a Social Security reform proposal that relies on higher projected returns in the stock market, then Congress must evaluate the proposal by reviewing a detailed description of their assumptions on stock returns.

The U.S. economy has grown at an annual rate of approximately 3.4 percent over the past 75 years. Likewise, stocks have provided rates of return of about 7 percent over this same period. The Social Security Trustees Report, however, assumes that economic growth over the next 75 years will slow down to 1.6 percent of GDP, less than half the rate of growth we've actually experienced over the past 75 years, to support the projections in the Social Security shortfall.

Accordingly, if Social Security trustees project a significant slowdown in the growth in the economy from 3.4 percent to 1.6 percent over the next 75 years, what annual rate of return do you project investments of payroll taxes in the stock market will receive over the next 75 years?

Answer: In CBO's long-range cost estimates, the expected real (inflation-adjusted) return is 3.3 percent for Treasury bonds, 3.8 percent for corporate bonds, and 6.8 percent for corporate equities.

Question: Also, please provide a detailed description of the return on stocks you project will support the investment accounts, breaking down the projections, on a year-by-year basis, into dividend payouts and capital gains.

Answer: CBO's assumptions about corporate equities are based on the *total* return to those assets, which includes both dividend payouts and capital gains. CBO does not make separate assumptions about dividend payouts and capital gains. CBO assumes that the total real (inflation-adjusted) return for corporate equities is 6.8 percent and that it is the same in every year of the projection.

CBO's assumption that the real return on equities does not change reflects a deeper assumption that the amount of capital investment in the economy adjusts so that the return on that investment reflects the costs of delayed consumption and increased risk that investors must face. Some analysts have argued that the return on corporate equities depends on the decisions that corporations make about how much to return to investors as dividends and how much to reinvest in the company to generate future capital gains for investors. Those decisions cannot alter the overall rate of return on equities, however, unless they somehow alter the overall level of capital investment.

RESPONSES TO QUESTIONS FROM SENATOR CRAPO

Question: My understanding of the Social Security trust fund is this: when Social Security collects more in payroll taxes than required to pay out in benefits, the government more or less spends this surplus in regular programmatic expenses, and then the government issues special bonds to account for having borrowed the funds.

- Is this accurate? If so, are the trust fund's special bonds better considered assets or liabilities?
- When Social Security surpluses begin to shrink in 2010, what are the expected impacts on the budget? And should we begin to prepare for these? Should all taxpayers be concerned about this date?

Answer: You are correct in your understanding. Surplus Social Security funds must be credited to the trust funds as Federal securities backed by the full faith and credit of the U.S. Treasury and in general take the form of special issue bonds. Because those bonds will surely be honored by the Secretary of the Treasury when they need to be redeemed in order to meet benefit requirements, they can be considered assets of the trust funds and liabilities of the Treasury. On the other hand, the underlying commitment to pay benefits is the real "liability" of the government; similarly, the real "asset" to provide the resources is the sovereign power of the government to tax.

When the Social Security surpluses begin to shrink, policymakers will have to take action to avoid additional debt accumulation. That action could include outlay reductions, revenue increases, or a combination of the two. The earlier planning begins, the less difficult that task will be.

Question: According to CBO (SSA) analysis, outlays will exceed revenue in 2020 (2018); thereafter the trust fund's bonds will have to be redeemed to pay for retiree benefits. But by Social Security redeeming these bonds, the U.S. Treasury is forced to figure out a way to come up with the money to pay for these bonds. Suffice it to say, the Treasury, and Congress, isn't always the best at finding ways to save money.

Under current assumptions, how much money would the Treasury be responsible for "coming up with" starting in 2020 (2018)?

Answer: The supplemental data file to CBO's *Updated Long-Term Projections for Social Security* (January 2005) includes projected annual deficits as a percentage of GDP. CBO projects a 2005 Social Security surplus of 0.65 percent of GDP. CBO projects that in 2020, the Social Security deficit (dedicated taxes less outlays) will be only 0.01 percent of GDP, but it will grow to more than 1 percent of GDP in

2030 and 1.4 percent of GDP in 2040. (That file also includes projections of GDP, so those figures can be converted into dollars as well.)

Question: You have said before that the sooner we act to address Social Security's long-term outlook problem, the more options we have.

Can you please describe what kind of choices and options will disappear the longer we wait to fix the current system? Can you actuarially describe what it means to the Social Security system and to our economy to wait?

Answer: The sooner efforts are made to address the long-term imbalance in the Federal budget—and in Social Security in particular—the less difficult the adjustments will be. Currently, workers, employers, and beneficiaries face uncertainty about the rules they will face in the future. Actions that resolve that uncertainty will allow those people to more confidently plan how to work, save, spend, and hire. Resolving uncertainty about the budgetary outlook for Social Security would also allow policymakers to better understand future budgetary constraints when considering other aspects of Federal budget policy.

Implementing gradual action today avoids the need for precipitous and disruptive action later—which could take the form of either sudden, large increases in taxes, which can depress work effort and incentives to invest, or sudden, large reductions in benefits. Phasing in programmatic changes allows for gradual accommodation, giving people time to modify their expectations and to adjust their work and saving behavior. For example, younger workers who learned that they would receive lower-than-anticipated retirement benefits would have many years to respond. They could work or save a little more each year. If the same benefit reductions were announced as those workers neared retirement, they might be forced to make dramatic changes in their behavior and still might not have time to accumulate sufficient savings.

In testimony before the Special Committee on Aging on February 3, 2005, CBO presented estimates of the effects of implementing an example policy of a 10-percent reduction in benefits. Those estimates showed that implementing benefit reductions earlier resulted in greater reductions in future debt burdens. Assuming no changes in other Federal revenues or outlays, such savings would allow future generations to receive higher benefits than they would under current law.

Question: When we analyze different reform proposals, how important is it to pay close attention to what is known as "sustainable solvency?"

Answer: Strictly speaking, the Social Security system is sustainable and solvent under current law. However, if no changes are made to law before 2052, CBO projects that solvency will be achieved through sudden and dramatic automatic reductions in benefit levels. Most current workers presumably expect that some changes will be made in the next 47 years, but it is unclear what those changes will be.

By changing scheduled benefits and taxes so that no automatic benefit reductions would be needed, individuals would be better able to plan for their financial future. Sustainable solvency means that the system would be solvent in all future projections. Such projections are necessarily uncertain, and future legislative action would likely be necessary at some point, but ideally policymakers would put the system on a path where there was no expectation of future changes. Placing the system on such a path would not eliminate the need for future changes, but it would minimize the expected changes.

Question: Should any "transition costs" of any reform plan be considered to be real costs; or are "transition costs" more simply accounting changes, in which off-balance sheet obligations of the government (that is, the "promises" made under the current system) are exchanged for on-balance sheet debt?

Answer: The term "transition costs" commonly refers to the additional savings that would be needed to shift from a pay-as-you-go social insurance system to a prefunded system. Increasing savings requires that current consumption be reduced—a real cost to the people who must consume less. (People may also choose to work more, which is equivalent to reduced consumption of leisure time.)

Within the Social Security system, current consumption can be reduced through two approaches. Reducing benefits would reduce the resources available to current beneficiaries, thus placing the burden of transition cost mostly on the elderly. Increasing taxes would reduce the resources available to current workers, placing the burden on a younger generation. The Federal Government could also borrow money to pay for a transition, but that would simply require future benefit reductions or revenue increases and shift the burden to later generations. Of course, those policies could be combined in many ways.

RESPONSES TO QUESTIONS FROM SENATOR KYL

Question: If Congress chooses to finance post-2020 obligations attributable to Social Security by raising taxes, how much would we have to increase income taxes per filer to make up the shortfall?

Answer: CBO projects a very small Social Security deficit in 2020, but the shortfall would grow over time. If the annual deficits were allocated evenly among all adult tax-filing units, the cost per filing unit would grow from about $10 per unit in 2020 to $1,200 per unit in 2030 (in 2005 dollars).

Question: If Congress chooses to make up the difference purely by cutting government spending, how much would spending in other areas have to be cut? What would the implications be for defense, homeland security, veterans' health care, and research accounts in the discretionary budget?

Answer: CBO projects a very small Social Security deficit in 2020, but the shortfall would grow over time, reaching 1.04 percent of GDP in 2030, for example. Although CBO's baseline budgetary outlook extends only through 2015, the *Long-Term Budget Outlook* (December 2003) included projections for spending through 2050 under three scenarios. In the intermediate scenario, discretionary spending would be 3.6 percent of GDP in 2030. Under that scenario, financing the entire Social Security deficit by a reduction in discretionary spending would imply approximately a 30 percent reduction in discretionary spending.

Question: Assuming that Congress were to pursue this latter course—even without any changes in other entitlement programs—how much of the budget would be consumed by mandatory expenditures, that is, interest payments and entitlement spending?

Answer: Under the same scenario, if discretionary spending were reduced by 30 percent, discretionary spending would account for 10 percent of total outlays, not including interest; mandatory spending, including Social Security, would account for 90 percent.

Question: Over the 75-year time-frame that is the standard horizon used in discussions of Social Security's funding problems, what is the estimated shortfall in Social Security revenues compared with obligations, expressed as a percentage of GDP? If the shortfall were covered by increased taxes, what level as a percentage of GDP would taxes reach in this time period?

Answer: CBO estimates a 75-year summarized actuarial balance of –0.40 percent of GDP. In the *Long-Term Budget Outlook,* CBO included two tax scenarios. In one, Federal revenues equaled 18.4 percent of GDP—the average level of the past 30 years—in the long term. Under that scenario, increasing revenues by 0.4 percent of GDP would be a 2.2 percent increase. In the other scenario, current law remained in place, and revenues grew relative to GDP, reaching 24.7 percent in 2050. An increase in revenues from 24.7 percent of GDP to 25.1 percent would be a 1.6 percent increase. Although such a policy would balance the system over 75 years, additional changes would be required beginning in the 76th year.

Question: What do you think removing these additional resources from the private sector, where they are directed by the free and informed choices of individuals in the marketplace, will do to our economic growth? In other words, if taxes were increased to this level, how much of a burden on the economy would this be, and how do you think the economy would respond?

Answer: The effect on the economy would depend on how the revenue was raised. Raising marginal income tax rates, rather than reducing Social Security benefits, would almost certainly reduce the level of economic activity by reducing incentives to work and save. Less saving would slow investment in new business plants and equipment. Reduced participation in the labor market, fewer hours of work, and slower growth of the capital stock would work to reduce the amount of income that the economy could generate. Based on the macroeconomic analysis presented in CBO's 2003 long-term budget outlook, raising Federal revenues by 1 percent of gross national product (GNP) with higher marginal income tax rates and using the proceeds to finance additional transfers to the elderly would reduce real GNP by about 1 percent in 2050.

By contrast, some changes to the income tax system (such as reducing the child tax credit or scaling back certain exemptions or deductions) could spur some people to work or save more to make up for the lost income, which might have positive effects on GNP.

Question: If Congress tried to address program shortfalls by raising payroll taxes, what might the economic consequences of such an increase be?

Answer: The answer depends on how the budget shortfalls would otherwise be made up if payroll taxes were not raised. If the alternative was to cut Social Security benefits, higher payroll tax rates could reduce some people's participation in the labor market and might reduce the hours they work. The impact on national saving (the sum of private and government saving) is less certain: higher payroll taxes could reduce private saving, but they could increase government saving.

RESPONSES TO QUESTIONS FROM SENATOR LINCOLN

SOCIAL SECURITY TRUST FUND

Question: For the last 2 decades we have borrowed from the Social Security trust fund and spent that money in the general fund. Approximately $1.5 trillion plus interest is owed to the Social Security system by the general fund. Is that correct?

Answer: U.S. Treasury securities in the Social Security trust fund accounts totaled $1.7 trillion at the end of 2004, compared with $31 billion at the end of 1984. So the total increase in the trust fund balance, including interest, was $1.7 trillion over that period.

Question: How do you think the government is going to pay for that?

Answer: When the trust funds require cash to pay for benefits, the Treasury will use the funds available at the time to pay those benefits. Those funds could be supplied by running surpluses, which would require outlay reductions or revenue increases. If the rest of the budget is not in surplus, the government would borrow more from the public. In this way, Social Security is no different from any other government program.

Question: The headline from a recent article in the *Financial Times* read "Central banks shun U.S. assets." The article says that central banks are "shifting reserves away from U.S. assets and towards the eurozone," which could undermine the dollar's value on currency markets. What happens if no one wants to buy our debt? Would we have any other alternative other than turning to the American people to take on this debt?

Answer: It is certainly true that when foreigners become less willing to hold dollar assets, the main effect is on the value of the dollar, which declines until dollar assets become cheap enough to foreigners to make those assets attractive. In addition, interest rates may rise in the United States, also making dollars more attractive. The lower dollar makes foreign goods more expensive, so all U.S. consumers bear the cost.

Indeed, whether or not foreigners purchase government debt, the American people still bear its burden. When foreigners buy a portion of the debt, we dedicate a portion of tax revenues to pay interest to foreigners. When U.S. residents purchase the debt, those purchases displace productive investments that might have been made in the U.S. economy. Either way, debt reduces the future income available to U.S. residents, and that is the burden of debt.

Question: How much would we have to raise the income tax to cover saving the Social Security surplus rather than spending it on the general fund?

Answer: In 2005, CBO projects that the Social Security surplus will amount to about $169 billion, of which $91 billion will be interest. Raising $169 billion through the income tax would be equivalent to increasing those taxes by about 19 percent. Just covering the cash flow surplus in Social Security would require about a 9 percent increase in income taxes.

Question: If we borrow money at interest to create individual savings accounts and we have to borrow that money from foreigners and pay them interest with our taxes—aren't we actually lowering the net savings in America?

Answer: Not necessarily. Net national saving is private saving plus government saving (less depreciation). Borrowing money to create individual savings accounts would lower government saving, but in the absence of changes in individual savings behavior, it raises private saving by the same amount. So without behavioral changes, that policy would have no effect on net saving or borrowing from foreigners.

Analyzing behavioral changes is complicated. The evidence from 401(k) plans suggests that higher-income households might respond to those accounts by reducing their other saving, so the amount that total private saving increased might be less than the amount that government savings decreased. On the other hand, government might not spend as much if its revenues were lower. The net effect would depend on the balance of those two effects.

The analysis is also complicated by the fact that many proposals for personal accounts include other provisions that could affect national saving. For example, Plan 2 of the President's Commission to Strengthen Social Security reduced future outlays for Social Security by changing the benefit formula, which could significantly increase private saving. CBO estimates that Plan 2 (as a package) would increase net national saving and thereby boost the capital stock by 10 percent to 12 percent by 2080.

HEALTH CARE COSTS RELATIVE TO SOCIAL SECURITY

Question: I understand that Federal spending for Medicare is rising at a much faster rate than Federal funding for Social Security. As a matter of fact, Medicare costs will exceed Social Security costs in 2024 and will be twice as much as Social Security by the year 2078. In addition, the Medicare Health Insurance Trust Fund will be insolvent in 2019 as opposed to the Social Security trust fund which will be solvent until 2042 (or 2052 according to CBO).

I am not trying to negate the fact that Social Security is facing a long-term financial challenge that needs to be addressed, but if you were to prioritize these, it seems to me that rising Medicare/health care costs are a bigger issue. Would you like to comment?

Answer: There is little question that financing health care in the future presents the largest single fiscal challenge before the Federal Government. But it is also the fastest-growing portion of State budgets and an increasingly larger burden on the private sector. Rapidly growing health costs are a systemic phenomenon. Thus far, there have been few, if any, proposals that would significantly affect the problem of escalating health costs, and developing policy alternatives may take longer and be harder to reach consensus on than might be the case with Social Security.

Question: What are our options for dealing with these rising costs other than raising taxes, increased borrowing, or cutting benefits?

Answer: Those are the only options. And it is important to remember that different options carry varying degrees of risk and that risk-bearing carries a cost.

PERSONAL SAVINGS

Question: It is important that we find a way to increase individual and household savings in the U.S. Currently, there is a net negative savings rate in this country, meaning people owe more money than they're saving. What effect do we expect private accounts to have on increasing savings? Furthermore, what other options should be examined as a way to accomplish this goal?

Answer: The answer is uncertain and depends on the details of the proposal. Borrowing money to create individual saving accounts would lower government saving, but in the absence of change in individual savings behavior, it raises private saving by the same amount. So without behavioral changes, that policy would have no effect on net saving.

However, many proposals for personal accounts include other provisions that could affect national saving. For example, Plan 2 of the President's Commission to Strengthen Social Security reduced future outlays for Social Security by changing the benefit formula, which could significantly increase private saving. CBO estimates that Plan 2 (as a package) would increase net national saving and thereby boost the capital stock by 10 percent to 12 percent by 2080.

National saving could be raised in other ways. Reducing the government's budget deficit might increase national saving, provided that the policies used to reduce the deficit did not reduce private saving so much as to offset the gains in government saving. Tax policy could also be used to affect private saving. For example, a revenue-neutral change in our income tax system toward a consumption-based system could boost private saving.

SOLVENCY

Question: We know that introducing private accounts alone will not ensure the solvency of Social Security. In fact, it would move up the 2018 date by 10 years, to 2008. Although it may increase returns on assets, it does so at the cost of additional risk. Furthermore, it seems to me that any program that would divert money from the current system would make our problem worse. What role do private accounts alone play in solving the 75-year financial shortfall?

Answer: The effect of individual accounts on Social Security finances will depend on how a specific proposal is structured. In general, any plan that increases the total resources available to beneficiaries without increasing taxes or other forms of mandatory contributions will require additional Federal borrowing.

PRICE INDEXING

Question: As has been noted, current law ties initial benefits to wages. A recent memo from the Bush Administration has argued on behalf of price-indexing, a process that would adjust benefits to the rise in inflation. It is estimated that a change of this magnitude would result in a 46 percent benefit cut for a person retiring in 2075. In today's dollar, an average wage earner who began working in 1962 and retired in 2005, would receive nearly $400 less a month in benefits. According to Model 2, this reduction would happen whether you chose to participate in the private account or not.

Wouldn't this dramatic reduction put more people in poverty?

Answer: CBO does not have the capability to estimate the effects of changes to Social Security policy on poverty rates. Under current law, benefits will increase in real terms as real wages increase over time. Even accounting for the reduction in benefit levels that would occur under current law after trust funds are exhausted, CBO projects that average real benefits will be higher in 2053 than they are today. As a result, future poverty rates would be lower than they are today. To the extent that policy changes result in slower real benefit growth than would occur under current law, the poverty rate among Social Security beneficiaries would fall at a slower rate.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: I am extremely concerned about our Nation's rising debt. In CBO's budget report, you projected that next year interest expenses to finance our debt will exceed Federal spending on Medicaid.

- 2006 Interest expense: $213 billion; 2006 Medicaid spending: $193 billion.

This disturbing comparison illustrates how much our debt is costing us, to say nothing of how much it will cost future generations to pay off the debt.

Creating private accounts within Social Security will certainly require trillions of dollars in transition costs. And as I understand, President Bush expects to add this to our Nation's debt.

It seems to me that by adding it to our debt, we are just passing it on to our children who will have to pay higher taxes. Is it fair to characterize debt as simply future tax burden?

Answer: Debt is not a free lunch. It carries interest costs that must be financed one way or another. That means that future taxes would have to be higher than it would otherwise be, future spending would have to be lower than it would otherwise be, or some combination of both would have to occur.

Question: Can you please tell me what you would expect the annual additional interest payments to be if we added $2 trillion, above current baseline projections, to our national debt over the next 10 years?

Answer: If policy were changed so that outlays (excluding interest) were increased (or revenues reduced) by $160 billion in 2006, and that amount grew at the rate of GDP throughout the 2006–2015 period, total additional spending (or reduced revenues) would amount to $2 trillion. Factoring in the additional interest, such a policy would add $2.55 trillion to the national debt by the end of the period. The additional debt service cost in 2015 would approach $120 billion.

RESPONSES TO QUESTIONS FROM SENATOR SCHUMER

Question: You might not have this number handy, but I'd appreciate it if you could calculate it and get back to us. The President has promised to cut the budget deficit in half in 5 years, but this promise doesn't include the additional spending items I've mentioned here—the ongoing war costs, defense buildup, the costs of Social Security privatization, additional debt service, and so on. Could you give us a sense of how fast the economy would have to grow in real terms over the next 5 years for the President to both keep these other spending commitments and also halve the deficit?

Answer: It is not possible for CBO to provide this estimate at this point. CBO does not have enough details about the President's Social Security plan to estimate the costs of it. In addition, the President advanced a number of other proposals in his fiscal year 2006 budget submission, but CBO will not complete its analysis of the President's budget until early March.

Question: There's one thing that's really bothering me about this rush to privatize Social Security, particularly given Dr. Holtz-Eakin's testimony that the program is essentially sustainable in its current form, with minor changes. Back in 2001, the President used CBO's 10-year projected budget surplus to argue for his tax cuts, even though he was warned that the budget projections were unreliable and uncertain. Even Alan Greenspan said we should place a "trigger" on the tax cuts due to budget uncertainty. Once the budget returned to deficit, the Administration then argued that 10-year projections were, "not worth the paper they're printed on."

Now with Social Security, we're faced with projections that aren't 10 years into the future, but 40 and 50 years into the future. Given the uncertainty of such projections, do you believe that it would be more prudent to make incremental changes, and then come back in another 10 or 20 years if we need to tweak the program further, rather than attempting to partially privatize the system?

Answer: Although uncertainty is inevitable in any projections, the projected growth in Social Security outlays over the next 30 years is caused mainly by demographic factors. There is no uncertainty about the huge number of people born in the baby-boom generation and their impending retirement.

Two separate timing issues exist: when should legislation be enacted, and when should provisions—such as tax increases or benefit reductions—actually take effect? Policymakers may choose to delay implementation of certain provisions, although such delay would result in larger burdens on future generations. However, the earlier legislation is enacted, the more time people would have to adjust their behavior. In addition, certain changes would make the Social Security system more robust to unexpected economic or demographic outcomes, reducing the likelihood that future legislation would be needed.

PREPARED STATEMENT OF HON. TIM JOHNSON

I am pleased that the Senate Finance Committee is holding a hearing to review the long-term outlook for Social Security. Over recent weeks, I have noted my concern about President Bush's interest in privatizing Social Security, and I appreciate the opportunity to submit testimony today.

While the President has yet to release the details of any proposal outlining the specifics of his plan to reform Social Security, every indication is pointing in the direction of private accounts. I am deeply troubled by this idea and fear that such a measure will have severe repercussions for both the short run, as well as over the long-term course of the program.

In addition to protecting the retirement segment of the program, I believe that it is also important that these discussions include the protection of the disability insurance component of this program. Of the 45 million Americans who collect payments from the Social Security program, more than one-third (almost 17 million) are not retired workers. An estimated 8 million beneficiaries are in the category receiving Social Security Disability Insurance benefits. In my home State of South Dakota, there are more than 13,000 disabled workers who relied on Social Security benefits in 2003, as well as an additional 4,000 of their dependents. The average monthly benefit to a disabled worker in our State was $770 in 2002, according to the U.S. Census Bureau. According to the Social Security Administration, nearly 3 out of every 10 workers will become disabled at some point in their lifetime. These statistics could become a tragic reality to any one of us at any time.

Proposals to privatize Social Security currently involve shifting some of the money financing the current insurance program into investment accounts assigned to each worker. The President and his surrogates have been eager to point out the growth in these account balances that may occur if those investments are allowed to grow for several decades before retirees rely upon them. It is important for us to remember, however, that not all workers have the good fortune to work their entire lives without impairment. Workers who suddenly find themselves permanently and totally disabled may not have decades to leave their money growing in private investment accounts—they need to put food on the table today.

For many disabled workers, private accounts would be a "double whammy" at the time they most need assistance. Individual accounts of disabled workers would often be meager and insufficient to provide any real income protection for them. At the same time, the payroll taxes that would be carved out to pay for personal accounts are resources that are needed to support today's payments to disabled workers, their dependents, as well as those who rely upon retirement and survivors' benefits. If that support is diminished because funds are diverted to private accounts, the resulting cut in benefits could be catastrophic to disabled workers struggling with medical bills and other costs of their impairments.

Let's not forget that Social Security is more than a retirement program—it is also insurance against the catastrophic financial loss that can accompany a permanent and total disability. As we discuss changes to the Social Security system, we need to remember that the payroll taxes we pay into the system provide not only a source of income in retirement, but also help disabled people and their dependents make it through times of extreme hardship.

While President Bush's Social Security Commission has stated that it does not recommend cuts to the disability program, it did acknowledge that preserving existing disability and survivor's insurance greatly escalates the cost of financing private accounts. It is difficult to imagine how any Social Security privatization plan can avoid significant cuts in those essential protections.

The President has emphasized that it is important to revamp the program so that today's 20-year-olds will have security in the future when they retire. I believe there are things we can do to encourage savings, promote retirement planning and help people plan for possible misfortune, and that we can do so without dismantling the Social Security program as we know it. I would encourage today's young people and workers of all ages to consider the possibility that they could be faced with a disability in the future and may need to turn to Social Security before retirement age for assistance.

As I have said before, I am willing to work with the President and members of Congress to improve the long-term outlook of this program. However, I believe it is critical that any changes meet the needs of both current and future beneficiaries, including disabled individuals who have not been fortunate enough to work their entire lifetime without impairment.